Internal Revenue
cumulative
bulletin

1988–1

January-June

Department of the Treasury
Internal Revenue Service

988-1

T 22.25:

READEX FICHE best copy available

In This Issue

Statement of Principles of Internal Revenue Tax Administration ii
Introduction iii
Definition of Terms and Abbreviations iv
Numerical Finding List v
Finding List of Current Action on Previously Published Rulings vii
Tax Court 1
Part I.—Rulings and Decisions Under the Internal Revenue Code of 1986 3
Part II.—Treaties and Tax Legislation
  Table of Contents 407
    Subpart A.—Tax Conventions 408
Part III.—Administrative, Procedural and Miscellaneous 469
Notice of Proposed Rulemaking 879
Disbarments and Suspensions List 937
Index

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402

Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is "protecting the revenue." The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

These principles of tax administration were previously published in the Internal Revenue Bulletin as Revenue Procedure 64-22, 1964-1 (Part I) C.B. 689. They are restated here to emphasize their importance to all employees of the Internal Revenue Service.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

Cumulative Bulletin 1988-1 is a consolidation of all items of permanent nature published in the weekly Bulletins 1988-1 through 1988-26 for the period of January 1 through June 30, 1988.

The Internal Revenue Cumulative Bulletin is prepared in three parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986. Arrangement is sequential according to Code and regulations sections. The code section is shown at the top of each page.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Included in this Part is a list of persons disbarred or suspended from practice before the Internal Revenue Service.

Notice of Proposed Rulemaking
The preambles and text of proposed regulations that were published in the **Federal Register** during this six-month period are printed in this section.

The Bulletin Index-Digest System, a research and reference service supplementing the Bulletin, may be obtained from the Superintendent of Documents on a subscription basis. It consists of four Services: Service No. 1, Income Tax; Service No. 2, Estate and Gift Taxes; Service No. 3, Employment Taxes; Service No. 4; Excise Taxes. Each Service consists of a basic volume and a cumulative supplement that provides (1) finding lists of items published in the Bulletin, (2) digests of revenue rulings, revenue procedures, and other published items, and other published items, and (3) topical indexes of Public Laws, Treasury Decisions, and Tax Conventions.

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified **describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified, below*).**

Clarified **is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.**

Distinguished **describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.**

Modified **is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).**

Obsoleted **describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.**

Revoked **describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.**

Superseded **describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified and superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.**

Supplemented **is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.**

Suspended **is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.**

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

Numerical Finding List

Delegation Orders:
114 (Rev. 8), *470*
137 (Rev. 2), *470*
157 (Rev. 5), *470*
193 (Rev. 1), *470*
209 (Rev. 3), *471*

Notices:
88-1, *471*
88-2, *473*
88-3, *474*
88-4, *474*
88-5, *476*
88-6, *476*
88-7, *476*
88-8, *477*
88-9, *477*
88-10, *478*
88-11, *481*
88-12, *481*
88-13, *481*
88-14, *482*
88-15, *482*
88-16, *482*
88-17, *486*
88-18, *486*
88-19, *486*
88-20, *487*
88-21, *488*
88-22, *489*
88-23, *490*
88-24, *491*
88-25, *495*
88-26, *495*
88-27, *496*
88-28, *496*
88-29, *497*
88-30, *497*
88-31, *511*
88-32, *512*
88-33, *513*
88-34, *516*
88-35, *516*
88-36, *517*
88-37, *522*
88-38, *524*
88-39, *525*
88-40, *526*
88-41, *526*
88-42, *527*
88-43, *528*
88-44, *528*
88-45, *529*
88-46, *530*
88-47, *530*
88-48, *531*
88-49, *532*
88-50, *535*
88-51, *535*
88-52, *537*
88-53, *538*
88-54, *539*
88-55, *539*
88-56, *540*
88-57, *545*
88-58, *546*
88-59, *546*
88-60, *547*
88-61, *547*
88-62, *548*
88-63, *551*
88-64, *552*
88-65, *552*
88-66, *552*
88-67, *555*
88-68, *556*

Proposed Regulations:
EE-129-86, *880*
EE-162-86, *880*
EE-167-86, *881*
EE-184-86, *881*
INTL-52-86, *892*
INTL-932-86, *915*
INTL-941-86, *916*
INTL-990-86, *916*
INTL-128-87, *917*
INTL-313-87, *920*
INTL-491-87, *921*
INTL-905-87, *922*
LR-17-86, *923*
LR-97-86, *923*
LR-101-86, *924*
LR-114-86, *925*
LR-128-86, *925*
LR-137-86, *926*
LR-29-87, *927*
LR-39-87, *927*
LR-45-87, *929*
LR-55-87, *929*
LR-65-87, *930*
LR-83-87, *930*
LR-14-88, *932*
LR-26-88, *933*
LR-28-88, *933*
LR-29-88, *934*
LR-47-88, *935*
LR-53-88, *935*

Railroad Retirement Quarterly Rate:
344

Revenue Procedures:
88-1, *557*
88-2, *571*
88-3, *579*
88-4, *586*
88-5, *587*
88-6, *589*
88-7, *589*
88-8, *628*
88-9, *634*
88-10, *635*
88-11, *636*
88-12, *637*
88-13, *639*
88-14, *639*
88-15, *683*
88-16, *691*
88-17, *692*
88-18, *694*
88-19, *695*
88-20, *696*
88-21, *777*
88-22, *785*
88-23, *787*
88-24, *800*
88-25, *803*
88-26, *804*
88-27, *804*
88-28, *804*
88-29, *828*
88-30, *831*
88-31, *832*
88-32, *833*
88-33, *835*
88-34, *837*
88-35, *837*
88-36, *838*

Revenue Rulings:
88-1, *307*
88-2, *405*
88-3, *268*
88-4, *264*

Revenue Rulings—Cont.
88-5, *359*
88-6, *3*
88-7, *269*
88-8, *403*
88-9, *307*
88-10, *112*
88-11, *296*
88-12, *330*
88-13, *241*
88-14, *405*
88-15, *308*
88-16, *266*
88-17, *400*
88-18, *402*
88-19, *114*
88-20, *242*
88-21, *245*
88-22, *309*
88-23, *404*
88-24, *306*
88-25, *116*
88-26, *242*
88-27, *331*
88-28, *310*
88-29, *75*
88-30, *187*
88-31, *302*
88-32, *113*
88-33, *115*
88-34, *115*
88-35, *243*
88-36, *343*
88-37, *97*
88-38, *246*
88-39, *299*
88-40, *24*
88-41, *253*
88-42, *265*
88-43, *404*
88-44, *312*
88-45, *244*
88-46, *76*
88-47, *111*
88-48, *117*
88-49, *297*
88-50, *401*
88-51, *74*
88-52, *356*
88-53, *384*

Tax Conventions:
American Samoa, *408*
China, *414*
Shipping & Aircraft Agreements, *456, 458, 459, 460, 461, 462, 463, 464, 466, 467*

Treasury Decisions:
8165, *365*
8166, *254*
8167, *146*
8168, *80*
8169, *259*
8170, *118*
8171, *266*
8172, *383*
8173, *134*
8174, *399*
8175, *191*
8176, *94*
8177, *360*
8178, *313*
8179, *122*
8180, *363*
8181, *344*
8182, *258*
8183, *4*
8184, *49*

Treasury Decisions—Cont.
8185, *381*
8186, *37*
8187, *332*
8188, *327*
8189, *24*
8190, *394*
8191, *387*
8192, *397*
8193, *385*
8194, *186*
8195, *17*
8196, *325*
8197, *18*
8198, *270*
8199, *99*
8200, *351*
8201, *291*
8202, *78*
8203, *77*
8204, *246*
8205, *156*

Finding List of Current Action on Previously Published Rulings

Delegation Orders:

114 (Rev. 7)
Superseded by
114 (Rev. 8), *470*

137 (Rev. 1)
Superseded by
137 (Rev. 2), *470*

157 (Rev. 4)
Superseded by
157 (Rev. 5), *470*

193
Superseded by
193 (Rev. 1), *470*

209 (Rev. 2)
Superseded by
209 (Rev. 3), *471*

Notices:

88-1
Modified by
88-53, 538

Revenue Procedures:

72-29
Obsoleted by
88-19, *695*

73-37
Obsoleted by
88-19, *695*

75-10
Obsoleted by
88-19, *695*

75-22
Obsoleted by
88-19, *695*

76-3
Obsoleted by
88-19, *695*

76-5
Obsoleted by
88-19, *695*

77-7
Obsoleted by
88-19, *695*

77-33
Obsoleted by
88-19, *695*

77-46
Obsoleted by
88-19, *695*

78-39
Obsoleted by
88-19, *695*

79-37
Obsoleted by
88-19, *695*

80-30
Modified & Amplified by
88-8, *628*
Modified by
88-9, *634*

Revenue Procedures—Cont.

81-30
Amplified & Superseded by
88-31, *832*

83-36
Modified & Amplified by
88-8, *628*

88-41
Modified by
88-5, *587*
88-29, *828*

84-23
Modified & Amplified by
88-8, *628*

84-46
Modified & Amplified by
88-8, 628

84-48
Superseded by
88-32, *833*

84-49
Superseded by
88-33, *835*

84-50
Amplified & Superseded by
88-33, *835*

84-86
Modified & Amplified by
88-8, *628*

85-41
Superseded by
88-23, *787*

85-57
Amplified & Superseded by
88-6, *589*

87-1
Superseded by
88-1, *557*

87-2
Superseded by
88-2, *571*

87-3
Superseded by
88-3, *579*

87-4
Modified by
88-4, *586*
Modified & Amplified by
88-8, *628*

87-7
Superseded by
88-18, *694*

87-11
Superseded by
88-7, *589*

87-14
Superseded by
88-14, *639*

87-16
Superseded by
88-20, *696*

Revenue Procedures—Cont.

87-17
Superseded by
88-28, *804*

87-20
Modified by
88-30, *831*

87-23
Superseded by
88-3, *579*

87-30
Superseded by
88-3, *579*

87-35
Superseded by
88-3, *579*

87-37
Superseded by
88-3, *579*

87-46
Superseded by
88-3, *579*

87-50
Modified & Amplified by
88-8, *628*

87-52
Superseded by
88-20, *696*

87-56
Clarified & Modified by
88-22, *785*

87-59
Superseded by
88-3, *579*

87-62
Superseded by
88-36, *838*

88-1
Amplified by
88-6, *589*
Modified & Amplified by
88-8, *628*
Modified by
88-18, *694*
88-25, 803
Supplemented by
88-32, *833*
88-33, *835*

88-3
Modified by
88-25, *803*
88-26, *804*
88-34, *837*
88-35, *837*

88-5
Modified by
88-29, *828*

88-8
Modified by
88-13, *639*
88-27, 804

Finding List of Current Action on Previously Published Rulings—Continued

Revenue Rulings:

56-246
Obsoleted by
88-14, *405*

56-554
Revoked by
88-19, *114*

56-555
Revoked by
88-19, *114*

56-557
Revoked by
88-19, *114*

57-334
Revoked by
88-19, *114*

58-164
Revoked by
88-19, *114*

60-244
Obsoleted by
88-21, *245*

72-183
Amplified by
88-7, *269*

73-66
Obsoleted by
88-21, *245*

73-71
Modified by
88-11, *296*

73-227
Revoked by
88-3, *268*

74-586
Obsoleted by
88-21, *245*

75-50
Obsoleted by
88-21, *245*

75-132
Obsoleted by
88-2, *405*

75-142
Obsoleted by
88-2, *405*

76-11
Clarified by
88-51, *74*

76-379
Obsoleted by
88-21, *245*

76-475
Obsoleted by
88-21, *245*

76-531
Obsoleted by
88-21, *245*

77-50
Obsoleted by
88-21, *245*

Revenue Rulings—Cont.

77-152
Obsoleted by
88-21, *245*

77-408
Obsoleted by
88-21, *245*

78-49
Obsoleted by
88-21, *245*

78-419
Obsoleted by
88-12, *330*

79-58
Obsoleted by
88-21, *245*

84-28
Distinguished by
88-7, *269*

84-40
Amplified by
88-23, *404*
88-43, *404*

86-88
Supplemented by
88-36, *343*

87-101
Superseded by
88-40, *24*

Cumulative List of Announcements Relating to Decisions of the Tax Court Published in the Internal Revenue Bulletin from January 1, 1988 thru June 30, 1988

It is the policy of the Internal Revenue Service to announce in the Internal Revenue Bulletin at the earliest practicable date the determination of the Commissioner to acquiesce or not acquiesce in a decision of the Tax Court which disallows a deficiency in tax determined by the Commissioner to be due.

Notice that the Commissioner has acquiesced or nonacquiesced in a decision of the Tax Court relates only to the issue or issues decided adversely to the Government.

Actions of acquiescences in adverse decisions shall be relied on by Revenue officers and others concerned as conclusions of the Service only to the application of the law to the facts in the particular case. Caution should be exercised in extending the application of the decision to a similar case unless the facts and circumstances are substantially the same, and consideration should be given to the effect of new legislation, regulations, and rulings as well as subsequent court decisions and actions thereon.

Acquiescence in a decision means acceptance by the Service of the conclusion reached, and does not necessarily mean acceptance and approval of any or all of the reasons assigned by the court for its conclusions.

No announcements are made in the Bulletin with respect to memorandum opinions of the tax court.

The announcements published in the weekly Internal Revenue Bulletins are consolidated semiannually and annually. The semiannual consolidation appears in the first Bulletin for July and in the Cumulative Bulletin for the first half of the year and the annual consolidation appears in the first Bulletin for the following January and in the Cumulative Bulletin for the last half of the year.

The Commissioner ACQUIESCES in the following decisions:

Taxpayer	Docket No.	Report	
		Volume	Page
Honeywell, Inc.[1]	15807-83	87	624
Judge, William F. & Joan M.[2]	27103-84	88	1175
Kallich, Duke & Betty L.[3]	41781-86	89	676
King, Marlowe[4]	15350-84	89	445

The Commissioner does NOT ACQUIESCE in the following decisions:

Taxpayer	Docket No.	Report	
		Volume	Page
Doyle, Dane, Bernbach, Inc.[5]	14077-78	79	101
Larotonda, Jerry & Leonie[6]	17802-84	89	287
Magazine, Mary O., fka Mary O. Banks[7]	39207-86	89	321

---

[1] Acquiescence relating to whether an asset, which the taxpayer holds out for both lease and sale and which the taxpayer has previously elected to depreciate under the Class Life Asset Depreciation Range (CLADR) system set forth in section 1.167(a)-11 of the regulations, must be removed from the appropriate vintage account and its accumulated depreciation removed from the depreciation reserve of the vintage account when the asset is sold during the regular course of business after having initially been leased.

[2] Acquiescence relating to whether in cases where the Tax Court has jurisdiction to redetermine a deficiency in the underlying income tax, does the court also have jurisdiction to determine overpayments of additions to tax under sections 6651(a)(1), 6651(a)(2), and 6654 of the Code, with respect to that portion of the additions to tax applied to income tax reported on the return.

[3] Acquiescence relating to whether petitions can obtain small tax case designation under section 7463 of the Code and Tax Court Rules 170 et seq by conceding a certain monetary portion of respondent's deficiency determination without conceding the underlying issue which originated the notice of deficiency.

[4] Acquiescence relating to whether the transactions in gold were part of petitioner's commodity futures trade or business so that the interest incurred to carry the gold was not subject to the investment interest limitation of section 163(d) of the Code.

[5] Nonacquiescence relating to whether an accrual method taxpayer must include in its gross income for 1975 amounts representing claimed refunds of New York State franchise taxes and New York City general corporate taxes paid for 1972 which became refundable by virtue of a 1975 net operating loss carried back to 1972.

[6] Nonacquiescence relating to whether petitioner's constructive receipt of a Keogh account distribution by virtue of the government's levy on the account causes the Keogh owner to also be liable to the 10 percent premature distribution tax under section 72(m)(5) of the Code.

[7] Nonacquiescence relating to whether, in the absence of the relevant Postal Service Form 3877, respondent can prove the mailing and date of mailing of the statutory notice of deficiency by means of testimony showing the custom and habit of respondent's employee regarding the mailing of statutory notices.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Subpart A.—Income Taxes
Chapter 1.—Normal Taxes and Surtaxes
Subchapter A.—Determination of Tax Liability
Part IV.—Credits Against Tax
Subpart A.—Nonrefundable Personal Credits

Section 25.—Interest on Certain Home Mortgages

26 CFR 1.25-1T: Credit for interest paid on certain home mortgages.

The average area purchase price safe harbor limitations for new and existing single-family residences for the State of Iowa, as published in Rev. Proc. 87-20, 1987-1 C.B. 713, are corrected. See Rev. Proc. 88-30, page 831.

Subpart D.—Business Related Credits

Section 42.—Low-Income Housing Credit

Low-income housing credit; January 1988 appropriate percentages. This revenue ruling provides guidance to taxpayers concerning the general methodology that the Treasury Department will use in computing the monthly appropriate percentages for the 70-percent present value credit and the 30-pecent present value credit. The appropriate percentages for the 70-percent present value credit and the 30-percent present value credit for January 1988 are set forth. The appropriate percentages for succeeding months will be announced in the monthly revenue ruling containing the applicable federal rates.

Rev. Rul. 88-6

Section 42(a) of the Internal Revenue Code, which was added by section 252 of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 106, provides that the amount of the low-income housing credit determined under section 42 for any tax year in the credit period is an amount equal to the "applicable percentage" of the qualified basis of each qualified low-income building. Section 42(f)(1) defines the term "credit period" with respect to any building as the period of 10 tax years beginning with the tax year in which the building is placed in service or, at the election of the taxpayer, the succeeding tax year.

In the case of any qualified low-income building placed in service by the taxpayer after 1987, section 42(b)(2)(A) of the Code provides that the term "applicable percentage" means the appropriate percentage prescribed by the Secretary for the month in which the building is placed in service. Section 42(b)(2)(B) provides that the percentages prescribed by the Secretary for any month shall be percentages that will yield, over a 10-year period, amounts of credit that have a present value equal to (i) 70 percent of the qualified basis of new buildings that are not federally subsidized for the tax year, and (ii) 30 percent of the qualified basis of existing buildings and new buildings that are federally subsidized for the tax year.

Under section 42(b)(2)(C) of the Code, the present value under subparagraph (B) of section 42(b)(2) is determined (i) as of the last day of the first year of the 10-year period referred to in section 42(b)(2)(B), (ii) by using a discount rate equal to 72 percent of the average of the federal mid-term rate and the federal long-term rate applicable under section 1274(d)(1) to the month in which the building was placed in service and compounded annually, and (iii) by assuming that the credit allowable under section 42 for any year is received on the last day of such year.

The formula used to calculate the appropriate percentages for the 70-percent and 30-percent present value credits is shown in Table 1.

Table 1

Calculation of the Appropriate Percentage

Let:

AFR_M = mid-term applicable federal rate with an annual period for compounding, expressed as a percent

AFR_L = long-term applicable federal rate with an annual period for compounding, expressed as a percent

$i = (1.0 - 0.28) \times ([AFR_M + AFR_L] \div 200)$

$PV = 1.0 + ([1.0 - (1.0 \div [1.0 + i]^9)] \div i)$

If AP_{70} stands for the appropriate percentage for the 70-percent present value credit and AP_{30} stands for the appropriate percentage for the 30-percent present value credit, then, to express AP_{70} and AP_{30} as percents:

$AP_{70} = 70 \div PV$

and

$AP_{30} = 30 \div PV$

The model on the basis of which the above computations are made assumes 10 equal annual credit amounts. The legislative history contemplates that such a pattern of credits is to be used for these computations. *See generally* S. Rep. No. 313, 99th Cong., 2d Sess. 759-60 (1986), 1986-3 (Vol. 3) C.B. 759-60. Thus, the computations yield the same appropriate percentages for all buildings placed in service in a given month, regardless of whether taxpayers make the election under section 42(f)(1) of the Code to defer the credit period and regardless of the extent to which section 42(f)(2) causes the credit amounts actually received to deviate from the model described above.

The appropriate percentages determined under section 42(b)(2) of the Code for buildings that are placed in service in January 1988 are as follows:

9.15% for the 70-percent present value credit.

3.92% for the 30-perecent present value credit.

Because the computation of the monthly appropriate percentages is based in part on an average of the long-term and mid-term applicable federal rates, for months after January 1988 the monthly appropriate percentages for the 70-percent and 30-percent present value credits will be published in the monthly revenue ruling containing the applicable federal rates.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1988. See Rev. Rul. 88-9, page 307.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 1988. See Rev. Rul. 88-15, page 308.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1988. See Rev. Rul. 88-22, page 309.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 1988. See Rev. Rul. 88-28, page 310.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 1988. See Rev. Rul. 88-44, page 312.

Subpart E.—Rules for Computing Credit for Investment in Certain Depreciable Property

Section 46.—Amount of Credit

26 CFR 1.46-3(g): Public utility property.

Rev. Proc. 85-57, 1985-2 C.B. 740, is expanded to cover communications from recognized consumer advocates. See Rev. Proc. 88-6, page

---

26 CFR 1.46-5: Qualified progress expenditures.

T.D. 8183

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; SUBCHAPTER H, PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Investment Credit for Qualified Progress Expenditures

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the investment credit for qualified progress expenditures. Changes in the applicable tax law were made by the Tax Reduction Act of 1975 [1975-1 C.B. 545], the Tax Reform Act of 1976 [1976-3 C.B. (Vol. 1)1], and the Revenue Act of 1978 [1978-3 C.B. (Vol. 1)1]. These regulations provide the public with guidance needed to comply with the law.

DATES: The amendments to the Income Tax Regulations under the Tax Reduction Act of 1975 (1975 Act) (new §1.46-5) are effective upon publication and apply to taxable years ending after December 31, 1974. The amendments under the Tax Reform Act of 1976 (1976 Act) (§1.46-5(m) as applied to certain property) are effective upon publication and apply to taxable years ending after December 31, 1976. The amendments under section 312(b)(2) of the Revenue Act of 1978 (§1.46-5(m) as applied to certain property) are effective upon publication and apply to taxable years ending after December 31, 1978.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains final amendments to the Income Tax Regulations (26 CFR Part 1) under section 46(d) of the Internal Revenue Code of 1954, relating to the investment credit for qualified progress expenditures. These regulations were published in proposed form in the FEDERAL REGISTER on January 30, 1979 (44 FR 5910). A public hearing was held on June 27, 1979. After consideration of all comments regarding the proposed amendments, those amendments are adopted, as revised, by this Treasury decision.

Before the 1975 Act, the investment credit was available only in the year in which property was placed in service. Section 46(d) (as added by the 1975 Act) allows taxpayers to elect the investment credit for qualified progress expenditures made during construction of certain property. The property must be new section 38 property that takes at least two years to construct and has an estimated useful life of 7 years of more.

This Treasury decision adds a new §1.46-5 to provide rules for claiming the investment credit under section 46(d) for qualified progress expenditures. Under these rules, qualified progress expenditures made during a taxable year are added to a taxpayer's qualified investment otherwise determined under §1.46-3 for that year. However, expenditures made in a taxable year beginning before 1980 are not allowed in full in computing qualified investment for that year, but are phased-in over a 5-year period.

The final regulations amend §§1.47-1 and 1.47-3 to provide rules for recapturing the investment credit for progress expenditure property. In general, those rules are similar to the rules for recapture for other section 38 property. Special rules apply, however, for recapture involving certain leased property.

The final regulations also reflect certain amendments made by section 301 of the 1975 Act, sections 1701(b) and 1703 of the Tax Reform Act of 1976, and sections 311(a) and 312(b)(2) of the Revenue Act of 1978. Section 301 of the 1975 Act provides an alternative limitation on the amount of tax liability that may be offset by investment credit for public utility property. Sections 1701(b) and 1703 of the 1976 Act provide a similar limitation for railroad and airline property. Section 312(b)(2) of the 1978 Act consolidates the alternative limitations on railroad and airline property into sections 46(a)(8) before its repeal by section 205(b)(2)(A) of the Tax Equity and Fiscal Responsibility Act of 1982. The final regulations apply the alternative limitation to progress expenditure property that is public utility, railroad, or airline property for the period that those limitations are in effect.

The final regulations do not reflect subsequent amendments to the Code, such as those relating to recovery property made to section 46(d) by the Economic Recovery Tax Act of 1981, or the repeal of the alternative limitations on the investment credit for utility, airline, and railroad property.

DEFINITION OF CONSTRUCTION

Section 46(d)(2)(A) defines progress expenditure property, in part, as any property which is being constructed by or for the taxpayer, which has a normal construction period of two years or more, and which will be new section 38 property in the hands of the taxpayer when it is placed in service. Section 1.46-5(c)(2)(ii) of the proposed regulations defined construction as building or manufacturing property from materials and component parts. That section further provided that construction did not include activities such as cultivating orchards, raising livestock, or creating a motion picture film or videotape. Some commentators argued that the exclusion of these activities from the meaning of construction is not supported by section 46(d) or the legislative history. The commentators contended specifically that orchards may be treated as new section 38 property in the year in which they reach an income-producing stage and that there is no basis to exclude any particular type of new section 38 property from progress expenditure treatment. They also argued that the proposed regulations were inconsistent with Rev. Rul. 69-249 (1969-1 C.B. 31), which held that the underlying purpose and principles of "construction" as used in section 48(b) of the Code are equally applicable to the planting and development of an orchard.

As evidenced by the examples of ships, pipelines, and machinery in the legislative history (H.R. Rep. No. 19, 94th Cong., 1st Sess. 37-43 (1975)), Congress intended in defining progress expenditure property that the term "construction" have its ordinary meaning. Section 48(b) contains a transitional rule which determines the portion of the basis of property to be taken into account when computing the investment credit. For purposes of the transitional rule, property is divided into two categories: property constructed by the taxpayer and property acquired by the taxpayer. Although an orchard is not constructed in the ordinary sense of the word, an orchard was properly assigned to that category in order to apply section 48(b) to the facts of the ruling. Because the provisions of sections 46(d) and 48(b) have different purposes, a similar stretching of the meaning of "construction" is neither mandated nor intended in order to implement section 46(d). Accordingly, §1.46-5(d) of the final regulations provides that property, which is being constructed by or for the taxpayer, is progress expenditure property only if it is built or manufactured from materials and component parts. Thus, progress expenditure property does not include property such as orchards, vineyards, livestock, or motion picture films or videotapes.

Another commentator suggested that the proposed definition of construction would arguably exclude from the definition of qualified progress expenditures for non-self-constructed property an amount paid for designs or plans or to acquire materials to be used in construction because it is not an amount paid "for construction" under section 46(d)(3)(B)(i). To clarify the interpretation of "for construction", §1.46-5(j)(1) of the final regulations provides examples of expenditures for construction of non-self-constructed property. Whether an amount paid to acquire materials for use by a taxpayer's employees in construction of a portion of non-self-constructed property is a qualified progress expenditure is determined under §1.46-5(j)(2) of the final regulations (see discussion of qualified progress expenditures below). Materials acquired by a taxpayer and delivered to a manufacturer or contractor for construction may constitute an amount paid in the form of property under §§1.46-5(d)(3)(iii) and 1.46-5(j)(4) of the proposed and final regulations, respectively.

NORMAL CONSTRUCTION PERIOD

General Rule

Under section 46(d)(2)(B), the normal construction period begins on the date physical work on construction of the property begins and ends on the date when it is expected that the property will be available for placing in service. For a determination of the normal construction period, §1.46-5(c)(2)(i) of the proposed regulations provided that physical work on construction does not include preliminary activities such as planning or designing, securing financing, exploring, researching or developing. One commentator recommended that the final regulations provide a general rule and examples describing the types of activities that constitute the commencement of physical work on construction. Other commentators suggested that the normal construction period should be measured from the earlier of the beginning of on-site construction of progress expenditure property or the start of off-site manufacture of a component unique to the progress expenditure property. Instead of a general rule, §1.46-5(e)(1) of the final regulations provides that the time when physical work on construction commences is based on the facts and circumstances of each case, because of the diversity of activities that may mark the onset of construction. That section also provides that physical work on construction may include the manufacture of a component to be placed in service as part of the property if designated specifically for that property. Generally, physical work on construction does not include physical activity that is not necessary to complete construction of the property, nor does it include physical work on construction of a building or other property that will not be new section 38 property when placed in service.

Taxpayers also observed that a blanket description of research and development as not constituting the beginning of physical work on construction was overly broad and could be construed to disqualify work on property any part of the cost of which is deductible under section 174. Accordingly, these activities have been removed from the list of excluded activities in §1.46-5(e)(1)(i) of the final regulations. Section 1.46-5(e)(1)(iii) clarifies that research and development activities in a laboratory or experimental setting are not physical work on construction. Whether other activities mark the beginning of physical work on construction will be determined from the facts and circumstances of each case as provided in §1.46-5(e)(1)(ii) of the final regulations.

Section 1.46-5(c)(2)(iv) of the proposed regulations, interpreting section 46(d)(2)(B)(ii), provided that the normal construction period ends on the date it is expected the property will be available to be placed in service. One commentator believed that the phrase in the statute "available for placing in service" should be interpreted in the same manner as the phrase "placed in service" so that the regulations under section 46(d) coincide with §1.46-3(d). The rule remains unchanged in the final regulations (§1.46-5(e)(1)(iv)). There is no support in the legislative history for construing obviously different phrases similarly. Further, §1.46-3(d) provides rules for determining when section 38 property is placed in service for purposes of computing qualified investment and claiming the investment credit in the proper taxable year. The provision of the final regulations only determines the time when construction of property has been completed, not when the investment credit for that property is allowed.

Estimate of normal construction period

Section 1.46-5(c)(2)(iii) of the proposed regulations required a taxpayer to attach to its income tax return a statement of the basis relied upon in estimating the normal construction period. In response to several comments, §1.46-5(e)(2) of the final regulations requires a taxpayer to attach a statement only if the estimate is not based on normal industry practice. The rule in the final regulations is prospective only.

Integrated unit

Both the proposed and final regulations provide that, if property is to be placed in service as part of an integrated unit, the normal construction period is determined for the unit as a whole. Under §1.46-5(c)(2)(v) of the proposed regulations, property is part of an integrated unit only if the operation of that item is essential to the performance of the function to which the unit is assigned. Although one commentator urged that the definition was too restrictive and difficult to apply, the definition remains unchanged in §1.46-5(e)(3)(ii) of the final regulations. The definition has been amplified, however, to explain that property essential to the performance of the function to which the unit is assigned includes property the use of which is significantly connected to that function and which effects the safe, proper, or efficient performance of the unit. The final regulations also provide that generally property must be placed in service at the same time to be considered part of the same integrated unit.

In response to several comments, §1.46-5(e)(3)(iii) clarifies that physical work on construction of an integrated unit may commence at a site different from the main construction site of the unit.

QUALIFIED PROGRESS EXPENDITURES

Whether progress expenditure property is self-constructed or non-self-constructed determines what amounts attributable to construction of the property may be treated as qualified progress expenditures. Self-constructed property, as defined in section 46(d)(5)(A), is property more than half of the construction expenditures for which it is reasonable to believe will be made directly by the taxpayer. All other property is non-self-constructed (section 46(d)(5)(B)). Under section 46(d)(3)(B), qualified progress expenditures for non-self-constructed property are amounts actually paid to another person for construction but only to the extent that the payments represent progress in construction. Progress is generally measured by the percentage of construction completed during a taxable year. Construction is presumed to occur not more rapidly than ratably throughout the construction period unless the taxpayer establishes otherwise by clear and convincing evidence. For self-constructed property, qualified progress expenditures are amounts properly chargeable to capital account during a taxable year with respect to that property (section 46(d)(3)(A)). Section 1.46-5(h)(1) of the final regulations makes clear that those amounts include both direct costs (for example, labor, materials, and parts) and indirect costs (for example, overhead and insurance). Because progress is expected to correspond to progress expenditures in the case of self-constructed property, the expenditures are not subject to the requirement of actual payment and the percentage-of-completion limitation applicable to expenditures for non-self-constructed property.

Commentators observed that the proposed regulations did not adequately consider property that is not entirely self-constructed or non-self-constructed. Section 1.46-5(h)(2) of the final regulations provides that amounts paid by the taxpayer to another person for construction of a portion of an item of self-constructed property are not subject to the limitations of section 46(d)(3)(B) (relating to actual payment and progress in construction) imposed upon expenditures for non-self-constructed property. For example, the percentage-of-completion limitation does not apply to payments made to a manufacturer for a turbine used in a ship if that ship is self-constructed property. Those payments are eligible for progress expenditure treatment when properly chargeable to capital account. Section 1.46-5(h)(3) of the final regulations provides rules for determining when amounts paid or incurred with respect to self-constructed property are properly chargeable to capital account.

For property that is non-self-constructed, but for which the taxpayer makes some construction expenditures directly, section 1.46-5(j)(2) of the final regulations provides that the rules of section 46(d)(3)(B) (relating to actual payment and progress in construction) and paragraph (j) of the regulations apply to determine if any expenditure (whether or not made directly by the taxpayer) is a qualified progress expenditure for non-self-constructed property. Wages actually paid to a taxpayer's employees are presumed to correspond to progress in construction. Other amounts, including expenditures for materials, parts, and overhead, must be actually paid, not borrowed from the payee, and attributable to progress made in construction.

Section 1.46-5(d)(3)(ii) of the proposed regulations required that a taxpayer apply the percentage-of-completion limitation to amounts paid to each manufacturer or contractor in each taxable year. Thus, progress is measured on a manufacturer by manufacturer basis, so that the taxpayer takes into account only those progress expenditures made to a manufacturer that was [sic] made progress (H.R. Rep. No. 19, *supra*, at 39). In response to comments that the proposed rule is unduly burdensome if applied at a subcontractor level, §1.46-5(j)(3) of the final regulations applies the requirement only with respect to persons that have a direct contractual relationship with the taxpayer (taking into account the progress made by those persons' subcontractors), rather than with respect to each subcontractor.

If, after the first year of construction, there is a change in either the total cost to the taxpayer or the total cost of construction by another person, §1.46–5(d)(3)(vi) of the proposed regulations required the taxpayer to recompute the percentage-of-completion limitation on the basis of the revised cost. Under the proposed rule, the recomputation would affect only years subsequent to the taxable year of change. Commentators contend that the recomputation should also apply to the taxable year in which the change occurs. This suggestion is adopted in §1.46–5(j)(6)(ii) of the final regulations.

While §1.46–5(c)(2)(i) of the proposed regulations excluded certain preliminary activities from a determination of the normal construction period, the proposed regulations did not specifically exclude from the definition of qualified progress expenditures amounts incurred prior to the commencement of the normal construction period. Taxpayers suggested that, once property has been determined to have a normal construction period of two years or more, such amounts should be eligible for progress expenditure treatment and should be included in qualified investment when made, or in any case, no later than in the year in which physical work on construction commences. The suggestion is not adopted. The regulations interpret the statute in a manner consistent with the legislative history, which provides that "progress expenditures", as well as "progress", are not to be taken into account to the extent that they occur before the start of the normal construction period (H.R. Rep. No. 19, *supra*, at 39). Accordingly, §1.46–5(g)(2)(i) of the final regulations excludes such amounts from the definition of qualified progress expenditures. That section also summarizes other amounts that are ineligible for progress expenditure treatment.

Section 46(d)(4)(A) does provide a limited "catch-up" rule. Under that section, property which is to be a component of, or otherwise included in, progress expenditure property is to be taken into account (1) at a time not earlier than the time it is irrevocably devoted to use in the progress expenditure property, and (2) as if the taxpayer (at that time) had expended an amount equal to that portion of the cost of the component which is properly chargeable to capital account with respect to the property. Thus, under §1.46–5(h)(3)(i), expenditures for component parts and materials for self-constructed property may not be considered chargeable to capital account until physical work on construction begins and the materials or parts become irrevocably devoted to use in the property.

Taxpayers have suggested that section 46(d)(4)(A) is also applicable to non-self-constructed property, and that once a component part is irrevocably devoted to the property and chargeable to capital account, the taxpayer is treated as having expended (*i.e.*, paid) an amount equal to the cost of the component part that has been charged to capital account. This amount, therefore, is a qualified progress expenditure without the application of the payment, progress, or borrowing rule. This suggestion is not adopted. Section 46(d)(4)(A) refers to the cost of a component part or other property which is properly chargeable to capital account with respect to the progress expenditure property in which the component part or other property is to be included, thus paralleling the definition of qualified progress expenditures for self-constructed property in section 46(d)(3)(A). Furthermore, the committee report refers specifically to self-constructed property in its explanation of "irrevocably devoted" as used in section 46(d)(4)(A) (H.R. Rep. No. 19, *supra*, at 38). There is no indication that Congress intended section 46(d)(4)(A) to override the payment, progress, and borrowing rules.

DEFINITION OF SELF-CONSTRUCTED PROPERTY

Self-constructed property is defined in section 46(d)(5)(A) as property more than half of the construction expenditures for which it is reasonable to believe will be made directly by the taxpayer. Under §1.46–5(d)(5) of the proposed regulations, construction expenditures are considered made "directly" by the taxpayer only if the taxpayer uses its own employees to construct the property. The majority of comments objected that this rule is unduly restrictive and inconsistent with the interpretation of the terms "construction completed by the taxpayer" in section 48(b) and "constructed by the taxpayer" in §1.48–2(b)(1).

Under §1.48–2(b)(1), property is constructed by the taxpayer if the work is done for him in accordance with his specifications. Courts interpreting this provision have focused on the taxpayer's right of control over construction (*Public Service Company of New Mexico v. United States*, 431 F.2d 980 (10th Cir. 1970); *Lykes Bros. Steamship Co., Inc. v. United States*, 513 F.2d 1342 (Ct. Cl. 1975)). In both cases, the property for which the investment credit was claimed was held to be acquired within the meaning of section 48(b)(2), rather than constructed by the taxpayer. The Service has announced that it will follow *Lykes Bros.* and a similar case, *Pacific Far East Line, Inc. v. United States*, 513 F.2d 1355 (Ct. Cl. 1975), in cases with identical factual situations. If a taxpayer engages the services of a contractor to construct property and the facts and circumstances show sufficient involvement of the taxpayer in the construction, the property is considered constructed by the taxpayer for purposes of section 48(b) (Rev. Rul. 77–107, 1977–1 C.B. 6).

As discussed in connection with the definition of construction, sections 46(d) and 48(b) have different purposes and need not be read *in pari materia*. Congress, aware of the distinction in section 48(b) between property constructed by the taxpayer and acquired property, used different terminology and established two different categories of progress expenditure property under section 46(d). The operating rules of section 46(d) governing expenditures for non-self-constructed property are designed to ensure that the investment credit is allowed only if the taxpayer has borne sufficient economic detriment and to prevent manipulation of the timing of the credit. These policy concerns exist whether the property is constructed by either a closely supervised or a completely independent contractor. Section 1.46–5(k)(1) of the final regulations, therefore, adopts the proposed rule for determining whether expenditures for construction are made directly by the taxpayer.

Section 1.46–5(k)(1) clarifies that construction expenditures include both direct costs, such as wages and materials, and indirect costs, such as overhead, attributable to construction of the property. Expenditures are considered made directly by the taxpayer only to the extent that the expenditures directly benefit the construction of the property by the taxpayer's employees. Thus, expenditures for material and supplies, which are used by employees of the taxpayer to construct progress expenditure property, are considered made directly by the taxpayer.

ELECTION

Under §1.46-5(g)(1) of the proposed regulations, the election under section 46(d) is binding for all progress expenditure property constructed or acquired by the taxpayer. Several commentators argued that the election should be made on a project-by-project basis. Because section 46(d) prescribes the timing of a credit, its effect is analogous to prescribing a method of accounting. The final regulations adopt the proposed rule, requiring a taxpayer to apply the progress expenditure election consistently to all eligible property.

Section 1.46-5(g)(1) of the proposed regulations also requires that the election under section 46(d) be made by each partner rather than by a partnership. The suggestion that the partnership make the election is not adopted because the investment credit affects the computation of tax and not the computation of taxable income. Thus, section 703(b), which generally requires a partnership to make elections affecting the computation of taxable income, is not applicable to the election under section 46(d). Section 1.46-5(o)(1) of the final regulations adopts the proposed rule to give each partner the flexibility to choose progress expenditure treatment and to ensure that the election binds the taxpayer even if it leaves the partnership. The final regulations also make clear that the election applies to all of a partner's progress expenditure property including property held in its own capacity.

Under §1.46-5(g)(2) of the proposed regulations, an election under section 46(d) must be made by filing a written statement containing specified information with the original return for the first taxable year to which the election will apply. In response to several comments, this requirement is not adopted in the final regulations. Instead §1.46-5(o)(2) provides that the election under section 46(d) is to be made on Form 3468. A transitional rule is also provided so that elections before the adoption of the final regulations will not be invalidated.

TRANSFERRED PROPERTY

Under §1.46-5(a)(2) of the proposed regulations, a transferee is entitled to qualified progress expenditures in the year the transferor, as a result of the transfer, must recapture the credit for progress expenditures previously allowed, and in subsequent years, if the transferee otherwise would be entitled to claim the credit with respect to that property. Taxpayers commented that it was unclear whether the transferee could treat the full amount paid to the transferor as qualified progress expenditures in addition to future payments for construction.

Section 1.46-5(r) of the final regulations contains a more comprehensive rule for transferred property with respect to which the transferor's election does not carry over to the transferee, and with respect to which the transferor must recapture the credit (if claimed). The transferee may treat the amount paid to the transferor as a payment for construction of the property to the extent that (A) it is properly includible in the basis of the property, (B) the taxpayer can show the amount is attributable to construction costs paid or chargeable to capital account after physical work on construction of the property began, and (C) it does not exceed the amount by which the transferor has increased qualified investment for qualified progress expenditures incurred with respect to the property (or would have increased qualified investment if the transferor had made an election under section 46(d)), plus any amount that would have been treated as a qualified progress expenditure by the transferor had the property not been transferred.

Once the status of the property as self-constructed property or non-self-constructed property in the hands of the transferee has been determined, all rules governing that type of property apply in determining the amount of the credit for qualified progress expenditures allowed to the transferee for that property. For example, the transferred property must have a normal construction period of two years or more in the hands of the transferee. Also, if the property is non-self-constructed property in the hands of the transferee, the transferee's expenditures with respect to the property (including the amounts paid to the transferor that are treated as amounts paid for construction) are subject to the limitations of section 46(d)(3)(B) (relating to actual payment and progress in construction). In the case of non-self-constructed property, however, the transferee determines the limitations of section 46(d)(3)(B) using the normal construction period of the transferor.

EXECUTIVE ORDER 12291 AND REGULATORY FLEXIBILITY ACT

The Commissioner of Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. The Internal Revenue Service has concluded that the final regulations contained herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

PAPERWORK REDUCTION ACT

The collection of information requirements contained in these regulations have been submitted to the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act of 1980. These requirements have been approved by OMB.

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Parts 1 and 602 are amended as follows:

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. *** Section 1.46-5 also issued under 26 U.S.C. 46(d)(6) and 26 U.S.C. 47(a)(3)(C).

Par. 2. Section 1.46-1 is amended by adding at the end of paragraph (g) a new paragraph (g)(6) and by adding at the end of paragraph (n) new examples (6) and (7) to read as set forth below.

§1.46-1 Determination of amount.

* * * * *

(g) *Transitional rule for regular and ESOP credit.* ***

(6) *Qualified progress expenditures.* For progress expenditure property that is constructed, reconstructed, or erected by the taxpayer within the meaning of §1.48-2(b), the ten-percent credit applies in the year the property is placed in service to the portion of the qualified investment that remains after reduction for qualified progress expenditures under section 46(c)(4), but only to the extent that the remaining qualified investment is attributable to construction, reconstruction, or erection after January 21, 1975. For progress expenditure property that is acquired by the taxpayer (within the meaning of §1.48-2(b)) after January 21, 1975, and placed in service after that date, the ten-percent credit applies in the year the property is placed in service to the entire portion of qualified investment that remains after reduction for qualified progress expenditures.

* * * * *

(n) *Examples.* ***

Example (6). (i) Corporation X, a calendar year taxpayer, constructs a ship on which it begins construction on January 1, 1973, and which, when placed in service on December 31, 1980, has a basis of $450,000. Of that amount, $100,000 is attributable to construction before January 22, 1975. X makes an election under section 46(d) (qualified progress expenditures) for taxable years after 1975.

(ii) For 1976, 1977, 1978, and 1979, qualified progress expenditures total $200,000. The ten-percent credit applies to those expenditures.

(iii) For 1980, qualified investment for the ship is $450,000. Under section 46(c)(4), X must reduce this amount by $200,000, the amount of qualified progress expenditures taken into account. The ten-percent credit applies to the portion of the remaining qualified investment attributable to construction after January 21, 1975 ($150,000). The seven-percent credit applies to the portion of qualified investment attributable to construction before January 22, 1975 ($100,000).

Example (7). (i) Corporation Y agrees to build a ship for Corporation X, which uses the calendar year. In 1973, Y begins construction of the ship which X acquires and places in service on December 31, 1980. X makes an election under section 46(d) for taxable years after 1974. The contract price is $400,000.

(ii) For 1975, 1976, 1977, 1978, and 1979, qualified progress expenditures total $250,000. The ten-percent credit applies to those expenditures.

(iii) For 1980, qualified investment for the ship is $400,000, which is the contract price. X must reduce qualified investment by $250,000, the amount of qualified progress expenditures. The ten-percent credit applies to the $150,000 of qualified investment that remains after reduction for qualified progress expenditures.

* * * * *

Par. 3. Section 1.46-3 is amended by adding a new sentence at the end of paragraph (a)(1) to read as follows:

§1.46-3 Qualified investment.

(a) *In general.* ***

(1) *** *See* §1.46-5 for special rules for progress expenditure property.

* * * * *

Par. 4. A new §1.46-5 is added immediately after §1.46-4 to read as follows:

§1.46-5 Qualified progress expenditures.

(a) *Effective date.* This section applies to taxable years ending after December 31, 1974. This section reflects amendments to the Internal Revenue Code made only by the Tax Reduction Act of 1975, the Tax Reform Act of 1976, and the Revenue Act of 1978.

(b) *General rule.* Under section 46(d), a taxpayer may elect to take the investment credit for qualified progress expenditures (as defined in paragraph (g) of this section). In general, qualified progress expenditures are amounts paid (paid or incurred in the case of self-constructed property) for construction of progress expenditure property. The taxpayer must reasonably estimate that the property will take at least 2 years to construct and that the useful life of the property will be 7 years or more. Qualified progress expenditures may not be taken into account if made before the later of (i) January 22, 1975, or (ii) the first taxable year to which an election under section 46(d) applies. In general, qualified progress expenditures are not allowed for the year property is placed in service, nor for the first year or any subsequent year recapture is required under section 47(a)(3). There is a percentage limitation on qualified progress expenditures for taxable years beginning before January 1, 1980. For a special rule relating to transfers of progress expenditure property, see paragraph (r) of this section.

(c) *Reduction of qualified investment.* Under section 46(c)(4), a taxpayer must reduce qualified investment for the year property is placed in service by qualified progress expenditures taken into account by that person or a predecessor. A "predecessor" of a taxpayer is a person whose election under section 46(d) carries over the taxpayer under paragraph (o)(3) of this section.

(d) *Progress expenditure property.* Progress expenditure property is property constructed by or for the taxpayer, with a normal construction period of 2 years or more. The taxpayer must reasonably believe that the property will be new section 38 property with a useful life of 7 years or more when placed in service. Whether property is progress expenditure property is determined on the basis of facts known at the close of the taxable year of the taxpayer in which construction begins (or, if later, at the close of the first taxable year to which an election under section 46(d) applies). For purposes of this paragraph (d), property is constructed by or for the taxpayer only if it is built or manufactured from materials and component parts. Accordingly, progress expenditure property does not include property such as orchards, vineyards, livestock, or motion picture films or videotapes.

(e) *Normal construction period*—(1) *In general.* (i) The normal construction period is the period the taxpayer reasonably expects will be required to construct the property. The period begins on the date physical work on construction of the property commences and ends on the date the property is available to be placed in service. The normal construction period does not include, however, construction before January 22, 1975, nor construction before the first day of the first taxable year for which an election under section 46(d) is in effect. Physical work on construction of property does not include preliminary activities such as planning, designing, preparing blueprints, exploring, or securing financing.

(ii) The determination of the time when physical work on construction commences is based on the facts and circumstances of each case. Physical work on construction of property may include the physical work done by a subcontractor on a component specifically designated as part of the property. Also, the commencement of physical work on construction may occur at a site different from the main site of construction of the property. For example, if a shipyard orders a turbine before it begins work on building a ship, the normal construction period of the ship is measured from the time the subcontractor commences physical work on construction of the turbine (if it is normal for such work to precede the work of the main contractor).

(iii) Generally, physical work on construction does not include physical activity that is not necessary to complete construction of the property, nor does it include physical work on construction of a building or other property that will not be new section 38 property when placed in service. Physical work on construction also does not include research and development activities in a laboratory or experimental setting.

(iv) The normal construction period of property ends on the date it is expected the property will be available to be placed in service. Property is considered available to be placed in service when construction is completed and the property is available for its assigned function or available for delivery to the site of its assigned function. It is not necessary that property be in a state of readiness for a specifically assigned function. Nor is it necessary that it actually be delivered to the site of its assigned function.

(2) *Estimates*. Taxpayers should refer to normal industry practice in estimating the normal construction period of particular items. A different period may be used if special circumstances exist making it impractical to make the estimate on the basis of normal industry practice. The estimate must be based on information available at the close of the taxable year in which physical work on construction of the property begins, or, if later, at the close of the first taxable year for which an election under section 46(d) is in effect for the taxpayer. If the estimate is reasonable when made, the actual time it takes to complete the work is, in general, irrelevant in determining whether property is progress expenditure property. However, if there is a significant error in estimating the normal construction period, it may be evidence that the estimate was unreasonable when made. For taxable years ending after April 1, 1988, a taxpayer not relying on normal industry practice to estimate the normal construction period of particular property must attach to the tax return for the taxable year in which physical work on construction of the property beings (or, if later, the first taxable year for which an election under section 46(d) is in effect) a statement of the basis relied upon in estimating the normal construction period of the property.

(3) *Integrated unit*. (i) In determining whether property has a normal construction period of 2 years or more, property that will be placed in service separately is to be considered separately. For example, if two ships are contracted for at the same time, each ship is considered separately under this paragraph. However, for property that will be placed in service as an integrated unit, the taxpayer must determine the normal construction period of the integrated unit. If the normal construction period of the integrated unit is 2 years or more, the normal construction period of each item of new section 38 property that is a part of the integrated unit is considered to be 2 years or more. Thus, the normal construction period of an integrated unit may be 2 years or more even if no part of the unit has a normal construction period of 2 years or more.

(ii) Property is part of an integrated unit only if the operation of that item is essential to the performance of the function to which the unit is assigned. Property essential to the performance of the function to which the unit is assigned includes property the use of which is significantly connected to that function and which effects the safe, proper, or efficient performance of the unit. Generally, property must be placed in service at the same time to be considered part of the same integrated unit. Properties are not an integrated unit, however, solely because they are to be placed in service at the same time.

(iii) The normal construction period for an integrated unit begins on the date the normal construction period of the first item of new section 38 property that is part of the unit begins. It is not necessary that physical work commence at the main construction site of the integrated unit. The period ends on the date the last item of new section 38 property that is part of that unit is available to be placed in service. Property that is not new section 38 property, such as a building, is not considered part of an integrated unit for purposes of determining the normal construction period of that unit. For example, if a manufacturing plant has a normal construction period of two years or more but the equipment (*i.e.*, new section 38 property) to be installed in the plant has a normal construction period of less than two years, the plant and the equipment do not constitute an integrated unit with a construction period of two years or more and the equipment is not progress expenditure property.

(4) *Examples*. The following examples illustrate this paragraph (e).

Example (1). On July 1, 1974, corporation X begins physical work on construction of a machine with an estimated useful life when placed in service of more than 7 years. For its taxable year ending June 30, 1975, X makes an election under section 46(d). For purposes of determining on June 30, 1975, whether the machine is "progress expenditure property", the normal construction period is treated as having begun on January 22, 1975. Thus, the machine will be considered to be progress expenditure property on June 30, 1975, only if the estimated time required to complete construction after June 30 is at least 18 months and 22 days (*i.e.*, 2 years less the period January 22, 1975, through June 30, 1975).

Example (2). (1) Corporation X constructs a pipeline in two sections and simultaneously begins physical work on construction of each section on January 1, 1976. One section extends from city M to city N. The other extends from city N to city O. Oil will be transferred to storage tanks at both city N and city O. Corporation X also begins construction on January 1, 1976, of a pumping station necessary to the operation of the pipeline from city M to city N. Construction of a pumping station necessary to the operation of the pipeline from city N to city O begins on June 30, 1977. For 1976, corporation X makes an election under section 46(d).

(ii) The section of pipeline from city M to city N and the associated pumping station will be available to be placed in service on January 1, 1977. Construction of the section of the pipeline from city N to city O will be completed on June 30, 1977. However, that section of the pipeline will not be available to be placed in service until completion of the associated pumping station on January 1, 1978.

(iii) The section of pipeline from city M to city N and the section from city N to city O must be considered separately in determining the normal construction period of the property. Each section will be placed in service separately. However, each section of the pipeline and the associated pumping station may be considered an integrated unit. The pumping stations are essential to the operation of each section of pipeline. Each section of pipeline and the associated pumping station are placed in service at the same time.

(iv) The section of pipeline from city M to city N and the associated pumping station are not progress expenditure property, because the normal construction period of that unit is only 1 year (January 1, 1976, to January 1, 1977).

(v) The section of pipeline from city N to city O and the associated pumping station are progress expenditure property, because the normal construction of that integrated unit is 2 years (January 1, 1976, to January 1, 1978). It is immaterial that neither the construction period of that section of pipeline (January 1, 1976 to June 30, 1977) nor the construction period of the associated pumping station (June 30, 1977 to January 1, 1978) is 2 years.

(vi) Assume the pumping station associated with the pipeline from city N to city O includes backup pumping equipment that will be used only if the primary pumping equipment fails. The backup equipment is part of the integrated unit because it serves to effect the safe or efficient performance of the unit.

(f) *New section 38 property with a 7 year useful life*—(1) *In general.* The taxpayer must determine if property will be new section 38 property with a useful life of 7 years or more when placed in service. The determination must be made at the close of the taxable year in which construction begins or, if later, at the close of the first taxable year to which an election under section 46(d) applies for the taxpayer.

(2) *Determination based on reasonably expected use.* The determination of whether property will be "new section 38 property" (within the meaning of §§1.48-1 and 1.48-2) when placed in service must be based on the reasonably expected use of the property by the taxpayer. There is a presumption that property will be new section 38 property if it would be new section 38 property if placed in service by the taxpayer when the determination is made. For example, in determining if property is an integral part of manufacturing under section 48(a)(1)(B)(i), it will be presumed that property will be new section 38 property if the taxpayer is engaged in manufacturing when the determination is made. Also, significant steps taken to establish a trade or business will be evidence the taxpayer will be engaged in that trade or business when the property is placed in service.

(3) *Estimated useful life.* The determination of whether property will have an estimated useful life of 7 years of more when placed in service must be made by applying the principles of §1.46-3(e). If the estimated useful life is less than 7 years when the property is actually placed in service, the credit previously allowed under section 46(d) must be recomputed under section 47(a)(3)(B).

(g) *Definition of qualified progress expenditures*—(1) *In general.* A taxpayer's qualified progress expenditures are the sum of (i) qualified progress expenditures for self-constructed property (determined under paragraph (h) of this section), plus (ii) qualified progress expenditures for non-self-constructed property (determined under paragraph (j) of this section). Only amounts includible under §1.46-3(c) in the basis of new section 38 property may be considered as qualified progress expenditures.

(2) *Excluded amounts.* Qualified progress expenditures do not include:

(i) In the case of non-self-constructed property, amounts incurred (whether or not paid)—

(A) Before the normal construction period begins, or

(B) Before the later of January 22, 1975, or the first day of the first taxable year for which an election under section 46(d) applies for the taxpayer;

(ii) In the case of self-constructed property, amounts chargeable to capital account—

(A) Before the normal construction period begins, or

(B) Before the later of January 22, 1975, or the first day of the first taxable year for which an election under section 46(d) applies for the taxpayer,

(See, however, section 46(d)(4)(A) and paragraph (h)(3)(i) of this section, relating to the time when amounts for component parts and materials are properly chargeable to capital account);

(iii) Expenditures with respect to particular property in the earlier of—

(A) The taxable year in which the property is placed in service, or

(B) The taxable year in which the taxpayer must recapture investment credit under section 47(a)(3) for the property or any subsequent year;

(iv) Expenditures for construction, reconstruction, or erection of property that is not section 38 property; or

(v) Amounts treated as an expense and deducted in the year paid or accrued.

(h) *Qualified progress expenditures for self-constructed property*—(1) *In general.* Qualified progress expenditures for self-constructed property (as defined in paragraph (k) of this section) are amounts properly chargeable to capital account in connection with that property. In general, amounts paid or incurred are chargeable to capital account if under the taxpayer's method of accounting they are properly includible in computing basis under §1.46-3. Qualified progress expenditures for self-constructed property include both direct cost (*e.g.*, labor, materials, parts) and indirect costs (*e.g.*, overhead, insurance) associated with construction of property to the extent those costs are properly chargeable to capital account.

(2) *Property partially non-self constructed.* If an item of property is self-constructed because more than half of the construction expenditures are made directly by the taxpayer, then any expenditures (whether or not made directly by the taxpayer) for construction of

that item of property are not subject to the limitations of section 46(d)(3)(B) and paragraph (j) of this section (relating to actual payment and progress in construction).

(3) *Time when amounts paid or incurred are properly chargeable to capital account.* (i) In general, expenditures for component parts and materials to be used in construction of self-constructed property are not properly chargeable to capital account until consumed or physically attached in the construction process. Component parts and materials that have been neither consumed nor physically attached in the construction process, but which have been irrevocably allocated to construction of that property are properly chargeable to capital account. Component parts and materials designed specifically for the self-constructed property may be considered irrevocably allocated to construction of that property at the time of manufacture of the component parts and materials. Component parts and materials not designed specifically for the property may be considered irrevocably allocated to construction at the time of delivery to the construction site if they would be economically impractical to remove. For example, pumps delivered to sites of construction of a tundra pipeline may be treated as irrevocably allocated to that pipeline on the date of delivery, even if they would be usable, but for their location on the tundra, in connection with other property. Component parts and materials are not to be considered irrevocably allocated to use in self-constructed property until physical work on construction of that property has begun (as determined under paragraph (e)(1)(ii) of this section). Mere bookkeeping notations are not sufficient evidence that the necessary allocation has been made.

(ii) A taxpayer's procedure for determining the time when an expenditure is properly chargeable to capital account for self-constructed property is a method of accounting. Under section 446(e), the method of accounting, once adopted, may not be changed without consent of the Secretary.

(4) *Records requirement.* The taxpayer shall maintain detailed records which permit specific identification of the amounts properly chargeable by the taxpayer during each taxable year to capital account for each item of self-constructed property.

(i) [Reserved].

(j) *Qualified progress expenditures for non-self-constructed property*—(1) *In general.* Qualified progress expenditures for non-self-constructed property (as defined in paragraph (l) of this section) are amounts actually paid by the taxpayer to another person for construction of the property, but only to the extent progress is made in construction. For example, such expenditures may include payments to the manufacturer of an item of progress expenditure property, payments to a contractor building progress expenditure property, or payments for engineering designs or blueprints that are drawn up during the normal construction period.

(2) *Property partially self-constructed.* If an item of property is non-self-constructed, but a taxpayer uses its own employees to construct a portion of the property, expenditures for construction of that portion are made directly by the taxpayer (see §1.46-5(h)(1)). Subject to the limitations of paragraph (g) of this section, those expenditures are qualified progress expenditures for non-self-constructed property if they satisfy the requirements of paragraph (j)(4), (5), and (6) of this section. Wages actually paid to the taxpayer's employees are presumed to correspond to progress in construction. Other amounts, including expenditures for materials, parts, and overhead, must be actually paid, not borrowed from the payee, and attributable to progress made in construction by the taxpayer.

(3) *Property constructed by more than one person.* The percentage of completion limitation (as prescribed in paragraph (j)(6) of this section), including the presumption of ratable progress in construction, applies to an item of progress expenditure property as a whole. However, if several manufacturers or contractors do work in connection with the same property, the progress that each person makes toward completion of construction of the property must be determined separately. Section 46(d)(3)(B) is then applied separately to amounts paid to each manufacturer or contractor based on each person's progress in construction. For example, assume the taxpayer contracts with three persons to build an item of equipment. The taxpayer contracts with A to build the frame, B to build the motor, and C to assemble the frame and motor. Assume each contract represents 33 1/3 percent of the construction costs of the property. If, within the taxable year in which construction begins, A and B each complete 50 percent of the construction of the frame and motor, respectively, amounts paid to A during that taxable year not in excess of 16 2/3 percent of the overall cost of the property, and amounts paid to B during that taxable year not in excess of 16 2/3 percent of the overall cost of the property, are qualified progress expenditures. Section 46(d)(3)(B) does not apply, however, to persons, such as lower-tier subcontractors, that do not have a direct contractual relationship with the taxpayer. If, in the above example, A engages a subcontractor to construct part of the frame, section 46(d)(3)(B) is applied only to amounts paid by the taxpayer to A, B, and C, but the portion of construction completed by A during a taxable year includes the portion completed by A's subcontractor.

(4) *Requirement of actual payment.* Qualified progress expenditures for non-self-constructed property must be actually paid and not merely incurred. Amounts paid during the taxable year to another person for construction of non-self-constructed property may be in the form of money or property (*e.g.*, materials). However, property given as payment may be considered only to the extent it will be includible under §1.46-3(c) in the basis of the non-self-constructed property when it is placed in service.

(5) *Certain borrowing disregarded.* Qualified progress expenditures for non-self-constructed property do not include any amounts paid to another person (the "payee") for construction if the

amount is paid out of funds borrowed directly or indirectly from the payee. Amounts borrowed directly or indirectly from the payee by any person that is related to the taxpayer (within the meaning of section 267) or that is a member of the same controlled group of corporations (as defined in section 1563(a)) will be considered borrowed indirectly from the payee. Similarly, amounts borrowed under any financing arrangement that has the effect of making the payee a surety will be considered amounts borrowed indirectly by the taxpayer from the payee.

(6) *Percentage of completion limitation.* (i) Under section 46(d)(3)(B)(ii), payments made in any taxable year may be considered qualified progress expenditures for non-self-constructed property only to the extent they are attributable to progress made in construction (percentage of completion limitation). Progress will generally be measured in terms of the manufacturer's incurred cost, as a fraction of the anticipated cost (as adjusted from year to year). Architectural or engineering estimates will be evidence of progress made in construction. Cost accounting records also will be evidence of progress. Progress will be presumed to occur not more rapidly than ratably over the normal construction period. However, the taxpayer may rebut the presumption by clear and convincing evidence of a greater percentage of completion.

(ii) If, after the first year of construction, there is a change in either the total cost of construction by another person, the taxpayer must recompute the percentage of completion limitation on the basis of revised cost. However, the recomputation will affect only amounts allowed as qualified progress expenditures in the taxable year in which the change occurs and in subsequent taxable years. The recomputation remains subject to the presumption of pro rata completion.

(iii) If, for any taxable year, the amount paid to another person for construction of an item of property under section 46(d)(3)(B)(i) exceeds the percentage of completion limitation in section 46(d)(3)(B)(ii), the excess is treated as an amount paid to the other person for construction for the succeeding taxable year. If for any taxable year the percentage of completion limitation for an item of property exceeds the amount paid to another during the taxable year for construction, the excess is added to the percentage of completion limitation for that property for the succeeding taxable year.

(iv) The taxpayer must maintain detailed records which permit specific identification of the amounts paid to each person for construction of each item of property and the percentage of construction completed by each person for each taxable year.

(7) *Example.* The following example illustrates paragraph (j)(6) of this section.

Example. (i) Corporation X agrees to build an airplane for corporation Y, a calendar year taxpayer. The airplane is non-self-constructed progress expenditure property. Physical work on construction begins on January 1, 1980. The normal construction period for the airplane is five years and the airplane is delivered and placed in service on December 31, 1984.

(ii) The cost of construction to corporation X is $500,000. The contract price is $550,000. Corporation Y makes a $110,000 payment in each of the years 1980 and 1981, an $85,000 payment in 1982, a $135,000 payment in 1983, and a $100,000 payment in 1984.

(iii) For 1980, corporation Y makes an election under section 46(d). Progress is presumed to occur ratably over the 5-year construction period, which is 20 percent in each year. Twenty percent of the contract price is $110,000. The percentage of completion limitation for each year, thus, is $110,000.

(iv) For each of the years 1980 and 1981, the $110,000 payments may be treated as qualified progress expenditures. The payments equal the percentage of completion limitation.

(v) For 1982, the $85,000 payment may be treated as a qualified progress expenditure, because it is less than the percentage of completion limitation. The excess of the percentage of completion limitation ($110,000) over the 1982 payment ($85,000) is added to the percentage of completion limitation for 1983. One hundred and ten thousand dollars minus $85,000 equals $25,000. Twenty-five thousand dollars plus $110,000 equals $135,000, which is the percentage of completion limitation for 1983.

(vi) For 1983, the entire $135,000 payment may be treated as a qualified progress expenditure. The payment equals the percentage of completion limitation for 1983.

(vii) For 1984, no qualified progress expenditures may be taken into account, because the airplane is placed in service in that year.

(viii) See example (2) of paragraph (r)(4) of this section for the result if Y sells its contract rights to the property on December 31, 1982.

(k) *Definition of self-constructed property*—(1) *In general.* Property is self-constructed property if it is reasonable to believe that more than half of the construction expenditures for the property will be made directly by the taxpayer. Construction expenditures made directly by the taxpayer include direct costs such as wages and materials and indirect costs such as overhead attributable to construction of the property. Expenditures for direct and indirect costs of construction will be treated as construction expenditures made directly by the taxpayer only to the extent that the expenditures directly benefit the construction of the property by employees of the taxpayer. Thus, wages paid to taxpayer's employees and expenditures for basic construction materials, such as sheet metal, lumber, glass, and nails, which are used by employees of the taxpayer to construct progress expenditure property, will be considered made directly by the taxpayer. Construction expenditures made by the taxpayer to a contractor or manufacturer, in general, will not be considered made directly by the taxpayer. Thus, the cost of component parts, such as boilers and turbines, which are purchased and merely installed or assembled by the taxpayer, will not be considered expenditures made directly by the taxpayer for construction. (*See* paragraph (h)(3) of this section to determine when such cost is properly chargeable to capital account.)

(2) *Time when determination made.* The determination of whether property is self-constructed is to be made at the close of the taxable year in which physical work on construction of the property begins, or, if later, the close of the first taxable year to which an election under this section applies. Once it is reasonably estimated that more than half of construction expenditures will be made directly by the taxpayer, the fact the taxpayer actually makes half, or less than half, of the expenditures directly will not affect classification of the property as self-constructed property. Similarly, once a determina-

tion has been made, classification of property as self-constructed property is not affected by a change in circumstances in a later taxable year. However, a significant error unrelated to a change in circumstances may be evidence that the estimate was unreasonable when made.

(3) *Determination based on certain expenditures.* For purposes of determining whether more than half of the expenditures for construction of an item of property will be made directly by the taxpayer, the taxpayer make take into account only expenditures properly includable by the taxpayer in the basis of the property under the provisions of §1.46-3(c). Thus, property is self-constructed property only if more than half of the estimated basis of the property to be used for purposes of determining the credit allowed by section 38 is attributable to expenditures made directly by the taxpayer.

(l) *Definition of non-self-constructed property.* Non-self-constructed property is property that is not self-constructed property. Thus, property is non-self-constructed property if it is reasonable to believe that only half, or less than half, of the expenditures for construction will be made directly by the taxpayer.

(m) *Alternative limitations for public utility, railroad, or airline property.* The alternative limitations on qualified investment under section 46(a)(7) and (8) for public utility, railroad, or airline property (whichever applies) apply in determining the credit for qualified progress expenditures. The determination of whether progress expenditure property will be public utility, railroad, or airline property (whichever applies) when placed in service must be made at the close of the taxable year in which physical work on construction begins or, if later, at the close of the first taxable year for which an election under section 46(d) is in effect. If, at that time, the taxpayer is in a trade or business as a public utility, railroad, or airline (as described in section 46(c)(3)(B) and 46(a)(8)(D) and (E), respectively), it is evidence the property will be public utility, railroad, or airline property when placed in service.

(n) *Leased property.* A lessor progress expenditure property may not elect under section 48(d) to treat a lessee (or a person who will be a lessee) as having made qualified progress expenditures.

(o) *Election*—(1) *In general.* The election under section 46(d)(6) to increase qualified investment by qualified progress expenditures may be made for any taxable year ending after December 31, 1974. Except as provided in paragraph (o)(2) of this section, the election is effective for the first taxable year for which it is made and for all taxable years thereafter unless it is revoked with the consent of the Commissioner. Except as provided in paragraphs (o)(2) and (3) of this section, the election applies to all qualified progress expenditures made by the taxpayer during the taxable year for construction of any progress expenditure property. Thus, the taxpayer may not make the election for one item of progress expenditure property and not for other items. If progress expenditure property is being constructed by or for a partnership, S corporation (as defined in section 1361(a)), trust, or estate, an election under section 46(d)(6) must be made separately by each partner or shareholder, or each beneficiary if the beneficiary, in determining his tax liability, would be allowed investment credit under section 38 for property subject to the election. The election may not be made by a partnership or S corporation, and may be made by a trust or estate only if the trust or estate, in determining its tax liability, would be allowed investment credit under section 38 for property subject to the election. The election of any partner, shareholder, beneficiary, trust, or estate will be effective for that person, even if a related partner, shareholder, beneficiary, trust, or estate does not make the election. An election made by a partner, shareholder, beneficiary, trust, or estate applies to all progress expenditure property of that person. For example, an election made by corporation X, which is a partner in the XYZ partnership, applies to progress expenditure property the corporation holds in its own capacity and also to its interest in progress expenditure property of the partnership.

(2) *Time and manner of making election.* An election under section 46(d)(6) must be made on Form 3468 and filed with the original income tax return for the first taxable year ending after December 31, 1974 to which the election will apply. An election made before March 2, 1988, by filing a written statement (whether or not attached to the income tax return) will be considered valid. The election may not be made on an amended return filed after the time prescribed for filing the original return (including extensions) for that taxable year. However, an election under this section may be made or revoked by filing a statement within an amended return filed on or before May 31, 1988, if the due date for filing a return for the first taxable year to which the election applies is before May 31, 1988.

(3) *Carryover of election in certain transactions.* In general, an election under section 46(d)(6) does not carry over to the transferee of progress expenditure property (or an interest therein). However, if under section 47(b) the property does not cease to be progress expenditure property because of the transfer, the election will carry over to the transferee. If so, the election will apply only to the property transferred. For rules relating to the determination of qualified progress expenditures of the transferee, see paragraph (r) of this section.

(p) *Partnerships, S corporations, trust, or estates*—(1) *In general.* Each partner, shareholder, trust, estate, or beneficiary of a trust or estate that makes an election under section 46(d) shall take into account its share of qualified progress expenditures (determined under paragraph (p)(2) of this section) made by the partnership, S corporation, trust, or estate. In determining qualified investment for the year in which the property is placed in service, the basis of the property is apportioned as provided in §§1.46-3(f), 1.48-6, or 1.48-5 (whichever applies). Each partner, shareholder, trust, estate, or beneficiary that made the election must reduce qualified investment under section 46(c)(4) for the year the property is placed in service by qualified progress expenditures taken into account by that person.

(2) *Determination of share of qualified progress expenditures.* The share of qualified progress expenditures of each partner, shareholder, trust, estate, or beneficiary that makes an election under section 46(d) must be determined in accordance with the same ratio used under §§1.46-3(f)(2), 1.48-5(a)(1), or 1.48-6(a)(1) (whichever applies) to determine its share of basis (or cost). The last sentence of §1.46-3(f)(2)(i) must be applied by referring to the date on which qualified progress expenditures are paid or chargeable to capital account (whichever is applicable).

(3) *Examples.* The following examples illustrate this paragraph (p).

Example (1). (i) Corporation X contracts to build a ship for partnership AB that qualifies as progress expenditure property. The contract price is $100,000. Physical work on construction of the ship begins on January 1, 1980. The ship is placed in service on December 31, 1983.

(ii) The AB partnership reports income on the calendar year basis. Partners A and B share profits equally. For A's taxable year ending December 31, 1980. A makes an election under section 46(d). B does not make the election.

(iii) For each of the years 1980, 1981, 1982, and 1983, the AB partnership makes $25,000 payments to corporation X. The payments made in 1980, 1981, and 1982 are qualified progress expenditures. The 1983 payment is not a qualified progress expenditure, because the ship is placed in service in that year.

(iv) For each of the years 1980, 1981, and 1982, A may take into account qualified progress expenditures of $12,500 because A had a 50 percent partnership interest in each of those years.

(v) For 1983, qualified investment for the ship is $100,000. A and B's shares are $50,000 each, because each had a 50 percent partnership interest in 1983. However, A must reduce its $50,000 share for 1983 by $37,500, the amount of qualified progress expenditures taken into account by A. B's share is not reduced, because B did not take into account qualified progress expenditures.

Example (2). (i) The facts are the same as in example (1) except that on June 30, 1983, the partnership agreement is amended to admit a new partner, C, to share profits equally. There is no special allocation in effect under section 704 with respect to the ship.

(ii) For each of the years 1980, 1981, and 1982, A may take into account qualified progress expenditures of $12,500 because A has a 50 percent partnership interest in those years.

(iii) For 1983, A, B, and C's share of qualified investment is $33,333 each, because each had a 33 1/3 percent partnership interest in that year. A must reduce its share to zero, because it took $37,500 into account as qualified progress expenditures. In addition, the excess of the $37,500 over the $33,333 applied as a reduction is subject to recapture under section 47(a)(3)(B). B and C's shares are not reduced, because neither taxpayer took into account qualified progress expenditures.

(q) *Limitation on qualified progress expenditures for taxable years beginning before 1980*—(1) *In general* (i) Under section 46(d)(7), qualified progress expenditures for any taxable year beginning before January 1, 1980, are limited. The taxpayer must apply the limitation under section 46(d)(7) on an item by item basis. In general, the taxpayer may take into account the applicable percentage (as determined under the table in section 46(d)(7)(A)) of qualified progress expenditures for each of those years. In addition, the taxpayer may take into account for each of those years 20 percent of qualified investment for each of the preceding taxable years determined without applying the limitations of sections 46(d)(7).

(ii) The applicable percentage under section 46(d)(7)(A) may be applied only for one taxable year that ends within a calendar year in determining qualified investment for an item of progress expenditure property. For example, calendar year partners of a calendar year partnership may increase qualified investment for 1976 by 20 percent of qualified progress expenditures made in 1975 for an item of property. If the partnership incorporates in 1976 and the taxable year of the corporation begins on July 1, 1976, and ends on June 30, 1977, qualified investment of the corporation for its taxble year beginning on July 1, 1976, cannot be increased by 20 percent of the 1975 expenditure.

(2) *Example.* The following example illustrates this paragraph (q).

Example. (i) Corporation X contracts with A on January 1, 1976, to build an electric generator that qualifies as non-self-constructed progress expenditure property. A will build the generator at a cost of $125,000. Corporation X agrees to pay A $150,000. Corporation X reports income on the calendar year basis. Corporation X makes an election under section 46(d) for 1976. Physical work on construction begins on January 1, 1976. Corporation X makes payments of $30,000 to A for construction of the generator in each of the years 1976, 1977, 1978, 1979, and 1980. A incurs a cost of $25,000 in each of those years for construction of the property. The property is placed in service in 1980.

(ii) For 1976, X may increase qualified investment by $12,000, 40 percent of the payment made in 1976.

(iii) For 1977, corporation X may increase qualified investment by $24,000. Eighteen thousand dollars of that amount is 60 percent of the 1977 payment. The remaining $6,000 is 20 percent of the $30,000 payment made in 1976.

(iv) For 1978, corporation X may increase qualified investment by $36,000. Twenty-four thousand dollars of that amount is 80 percent of the 1978 payment. The remaining $12,000 is 20 percent of the $30,000 payment made in 1976, plus 20 percent of the $30,000 payment made in 1977.

(v) For 1979, corporation X may increase qualified investment by $48,000. Thirty thousand dollars of that amount is 100 percent of the 1979 payment. The remaining $18,000 of that amount is 20 percent of the $30,000 payments made in each of the years 1976, 1977, and 1978.

(vi) Qualified investment for corporation X for 1980 is $30,000. The $30,000 is the basis (or cost) of the generator ($150,000), reduced by qualified progress expenditures allowed with respect to that property ($120,000).

(r) *Special rules for transferred property*—(1) *In general.* A transferee of progress expenditure property (or an interest therein) may take into account qualified progress expenditures for the property only if—

(i) The property is progress expenditure property in the hands of the transferee, and

(ii) The transferee makes an election under section 46(d) or the election made by the transferor (or its predecessor) carries over the transferee under paragraph (o)(3) of this section.

(2) *Status as progress expenditure property.* (i) If the transfer requires recapture under section 47(a)(3) and §1.47-1(g) (or would require recapture if the transferor had made an election under section 46(d)), then—

(A) For purposes of determining if the property is progress expenditure property in the hands of the transferee, the normal construction period for the property begins on the date of the transfer, or, if later, on the first day of the first taxable year for which the transferee makes an election under section 46(d), and

(B) For purposes of determining whether the property is self-constructed or non-self-constructed in the hands of the transferee, the amount paid or incurred for the transfer of the property will not be considered a construction expenditure made directly by the transferee.

(ii) If the transfer does not require recapture under section 47(a)(3) and §1.47-1(g), and the election carries over to the taxpayer under paragraph (o)(3) of this section, the property does not lose its status as progress expenditure property because of the transfer.

(3) *Amount of qualified progress expenditures for transferee.* (i) If the transfer does not require recapture under section 47(a)(3) and §1.47-1(g), and the election carries over to the taxpayer under paragraph (o)(3) of this section, the transferee must determine its qualified progress expenditures—

(A) By using the same normal construction period used by the transferor,

(B) By treating the property as having the same status as self-constructed or non-self-constructed as the property had in the hands of the transferor, and

(C) In the case of non-self-constructed property, by taking into account any excess described in section 46(d)(4)(C)(i) (relating to the excess of payments over the percentage-of-completion limitation) or section 46(d)(4)(C)(ii) (relating to the excess of the percentage-of-completion limitation over the amount of payments) that the transferor would have taken into account with respect to that property.

(ii) If the transfer requires recapture under section 47(a)(3) and §1.47-1(g) (or would require recapture if the transferor had made an election under section 46(d)), the amount paid or incurred for the transfer will be considered a payment for construction of that property to the extent that—

(A) It is properly includible in the basis of the property under §1.46-3(c),

(B) The taxpayer can show the amount is attributable to construction costs paid or chargeable to capital account by the transferor or other person after physical work on construction of the property began, and

(C) It does not exceed the amount by which the transferor has increased qualified investment for qualified progress expenditures incurred with respect to the property (or would have increased qualified investment but for the "lesser of" limitation of section 46(d)(3)(B) or the absence of an election under section 46(d)), plus any amount that would have been treated as a qualified progress expenditures by the transferor had the property not been transferred.

Once the status of the property as self-constructed or non-self-constructed property in the hands of the transferee has been determined, all rules under this section for determining the amount of qualified progress expenditures for that type of property apply. For example, if the property is non-self-constructed in the hands of the transferee, amounts merely incurred (but not paid) for the transfer are not taken into account as qualified progress expenditures. Actual payment is necessary (see paragraph (j)(3) of this section). In applying section 46(d)(3)(B)(ii), the amount paid or incurred for the transfer (to the extent that it qualifies as a payment for construction under the first sentence of this paragraph (r)(3)(ii)) is considered to be part of the overall cost to the transferee of construction by another person, and the portion of construction which is completed during the taxable year is determined by taking into account construction that was completed before the constructed property was acquired by the transferee. If the transferee makes an election under section 46(d) and this section for the taxable year in which the transfer occurs, then for purposes of applying the presumption in section 46(d)(4)(D) that construction is deemed to occur not more rapidly than ratably over the normal construction period, the transferee's normal construction period is considered to have begun on the date on which physical work on construction of the acquired property began.

(4) *Examples.* The following examples illustrate this paragraph (r)

Example (1). Corporation X begins physical work on construction of progress expenditure property for corporation Y on January 1, 1976. Y accurately estimates a 3-year normal construction period and elects under section 46(d) on its return for its taxable year ending December 31, 1976. On January 1, 1978, Y sells the contract rights for construction of the property to corporation Z, which uses a fiscal year ending June 30. Qualified progress expenditures allowed to Y in 1976 and 1977 are subject to recapture under section 47(a)(3f. Because Z's normal construction period for the property is less than 2 years (January 1, 1978 to January 1, 1979), the property is not progress expenditure property in Z's hands. Z may not elect progress expenditure treatment for the property.

Example (2). (i) Assume the same facts as in the example in paragraph (j)(7) of this section, except, on December 31, 1982, Y sells its contract rights to the property for $340,000 to corporation Z, which also uses the calendar year. Z pays Y the full $340,000 on that date. The property is still to be placed in service on December 31, 1984, and will not be available for placing in service at an earlier date. Z makes payments to X of $135,000 on December 31, 1983, and $110,000 on December 31, 1984.

(ii) The investment credit allowed Y in 1980 and 1981 for qualified progress expenditures is subject to recapture under section 47(a)(3) and Y may not treat its $85,000 payment in 1982 as a qualified progress expenditure.

(iii) For purposes of determining if the airplane is qualified progress expenditure property with respect to Z, the normal construction period for the property for Z begins on December 31, 1982, the date of transfer. Since the remaining construction period is two years, the property is progress expenditure property if it otherwise qualifies in Z's hands.

(iv) Only $305,000 of the $340,000 payment to Y can qualify as a qualified progress expenditure, because only that amount is attributable to construction costs paid by Y and does not exceed the sum of the amount by which Y increased qualified investment in 1980 and 1981 for qualified progress expenditures ($220,000) and the amount that Y would have treated as a qualified progress expenditure in 1982 ($85,000).

(v) Assume that Z cannot establish that progress in construction has been completed more rapidly than ratably. If Z makes an election under section 46(d) for 1982, then for purposes of applying the percentage of completion limitation, Z's normal construction period is considered to begin on January 1, 1980. Progress is presumed to occur ratably over the 5-year construction period, which is 20 percent in each year.

(vi) For 1982, Z may treat the full $305,000 as a qualified progress expenditure because it is less than the percentage of completion limitation, $330,000 ($110,000 a year for 1980, 1981, and 1982).

(vii) For 1983, Z may treat the entire $135,000 payment as a qualified progress expenditure, since it does not exceed the percentage of completion limitation for that year, $135,000 ($110,000 plus the $25,000 excess from 1982).

(viii) For Z's taxable year ending December 31, 1984, no qualified progress expenditures may be taken into account because the property is placed in service during that year.

Par. 5. Section 1.47-1 is amended by adding a new sentence at the end of paragraph (a)(1)(i) and by adding a new paragraph (g) to read as follows:

§1.47-1 Recomputation of credit allowed by section 38.

(a) *General rule*—(1) *In general.* (i) *** For special rules relating to recomputation of credit allowed by section 38 if progress expenditure property (as defined in §1.46-5(d) ceases to be progress expenditure property with respect to the taxpayer, see paragraph (g) of this section.

* * * * *

(g) *Special rules for progress expenditure property.* Under section 47(a)(3), a recapture determination is required if property ceases to be progress expenditure property (as defined in §1.46-5(d)). Property ceases to be progress expenditure property if it is sold or otherwise disposed of before it is placed in service. For example, cancellation of the contract for progress expenditure property or abandonment of the project by the taxpayer will be considered a "disposition" within the meaning of §1.47-2. A cessation occurs if progress expenditure property ceases to be property that will be section 38 property with a useful life of 7 years or more when placed in service. In general, a sale and leaseback is treated as a cessation. However, see paragraph (g)(2) of §1.47-3 for special rules for certain sale and leaseback transactions. Recapture determinations for progress expenditure property are to be made in a way similar to that provided under §§1.47-1 through 1.47-6. Reduction of qualified investment must begin with the most recent credit year (*i.e.*, the most recent taxable year the property is taken into account in computing qualified investment under §1.46-3 or 1.46-5).

Par. 6. Section 1.47-3 is amended by revising so much of paragraph (g) as precedes "Notwithstanding the provisions of" in the first sentence and by adding a new paragraph (g)(2). These new and revised provisions read as set forth below.

§1.47-3 Exceptions to the application of §1.47-1.

* * * * *

(g) *Sale-and-leaseback transactions*—(1) *In general.* ***

(2) *Special rule for progress expenditure property.* The sale and leaseback (or agreement or contract to lease-back) of progress expenditure property (including any contract rights to the property), in general, will be treated as a cessation described in section 47(a)(3)(A) with respect to the seller-lessee. However, a sale and leaseback (or agreement or contract to leaseback) will not be treated as a cessation to the extent qualified investment passed through to the lessee under section 48(d) in the year the property is placed in service equals or exceeds qualified progress expenditures for the property taken into account by the lessee. If a sale-leaseback transaction is treated as a cessation, qualified investment must be reduced and the credit recomputed, beginning with the most recent credit year (*i.e.*, the most recent year property is taken into account in computing qualified investment under §1.46-3 or 1.46-5). The amount of the reduction is the amount, if any, by which qualified progress expenditures taken into account by the lessee in all prior years exceeds qualified investment passed through to the lessee under section 48(d). This paragraph (g)(2) does not apply to any progress expenditure property that has been placed in service by a vendor-lessee (as described in paragraph (g)(1) of this section) prior to a sale-leaseback of that property in a transaction described in paragraph (g)(1) of this section.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 7. The authority citation for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 8. Section 602.101(c) is amended by inserting in the appropriate places in the table:

"§1.46-5(e)(2) . . . . 1545-0155",
"§1.46-5(h)(4) . . . . 1545-0155",
"§1.46-5(j)(6)(iv) 1545-0155", and
"§1.46-5(o)(2) . . . . 1545-0155".

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved February 9, 1988.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on March 1, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 2, 1988, 53 F.R. 6614).

Section 48.—Definitions; Special Rules

26 CFR 1.48-8: Motion picture and television films and tapes.

T.D. 8195

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1—INCOME TAX, TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Investment Credit for Movie and Television Films

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the investment credit for movie and television films and tapes. Changes to the applicable law were made by the Tax Reform Act of 1976. The regulations revise the definition of a qualified film and affect taxpayers that own movie and television films or tapes which they place in service.

DATES: The regulations are generally effective for taxable years beginning after December 31, 1974.

SUPPLEMENTARY INFORMATION:

One June 3, 1982, the FEDERAL REGISTER published proposed amendments (47 FR 24142) under section 48(k) of the Internal Revenue Code of 1954. Section 48(k) was added to the Code by the Tax Reform Act of 1976 to provide for an investment credit under section 38 for qualified films and tapes. Section 48(k)(1)(B) provides that "the term 'qualified film' means any motion picture film or video tape created primarily for use as public entertainment . . . [but] does not include any film or tape the market for which is primarily topical or otherwise essentially transitory in nature."

Pursuant to the existing regulations under section 48(k), the subject matter of the film or tape determines whether the market for that film or tape is topical or transitory. The proposed regulations proposed to amend §1.48-8(a)(3) to provide additional specificity as to the definition of a film that has a transitory market. The proposed regulations stated that a market for a film is essentially transitory if in the normal operation of the particular market for which the film is produced, films are generally shown once. By example, the proposed regulations provided that the market for serialized daytime dramas is essentially transitory in nature because films or tapes produced for that market usually are shown once. A number of comments were received, and a public hearing was held on October 14, 1982. After consideration of all comments, the Internal Revenue Service has promulgated these final regulations, which withdraw the proposed amendments relating to the definition of topical or transitory films and tapes. In addition, these final regulations amend the existing regulations under section 48(k) to remove the reference to game shows and variety shows as examples of topical or transitory films and tapes. As a result, the determination of whether or not a film or tape of such a game or variety show is topical or transitory will be made on a case-by-case basis.

These regulations do not reflect the repeal (with certain specified exceptions) of the regular investment credit by section 211 of the Tax Reform Act of 1986.

SPECIAL ANALYSES

Although a notice of proposed rulemaking that solicited public comment was issued, the Internal Revenue Service concluded when the notice was issued that the regulations are interpretive and that the notice and public procedure requirements of 5 U.S.C. 553 does not apply. Accordingly, the final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

The Commissioner of Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis is not required.

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

INCOME TAX REGULATIONS
PART 1

Paragraph 1. The authority for Part 1 continues to read as follows.

Authority: 26 U.S.C. 7805.***

Par. 2. Section 1.48-8 is amended by revising paragraph (a)(3)(iii) to read as follows:

§1.48-8 Motion picture and television films and tapes.

(a) *Entitlement to investment credit****

(3) *Qualified film****

(iii) *Topical or transitory films and tapes.* The term "qualified film" does not include any film or tape the market for which is primarily topical or is otherwise essentially transitory in nature. A film or tape is topical or essentially transitory in nature if it primarily deals with events and personalities of current interest at the time the film or tape is place in service. It does not matter that a film or tape which is topical or essentially transitory in nature may be shown in subsequent years or is actually shown in subsequent years. Topical or transitory films or tapes include news shows such as the evening new and news specials relating to current affairs, interview shows such as "The Tonight Show" or "Meet the Press", award shows, and shows consisting of sporting events. Topical or transitory films and tapes do not include dramatic shows (including dramatized recreations of recent events) or situation comedy shows which present entertainers as characters in a dramatization.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved April 4, 1988.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on April 15, 1988, 8:45 a.m., and published in the issue of the Federal Register for April 18, 1988, 53 F.R. 12677)

Part VI.—Alternative Minimum Tax

Section 56.—Adjustments in Computing Alternative Minimum Taxable Income

26 CFR 1.56-1T: Adjustment for the book income of corporations (temporary).

T.D. 8197

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Corporate Alternative Minimum Tax Book Income Adjustment of Foreign Corporations

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document provides rules for computing the alternative minimum tax adjustment for the book income of foreign corporations. Changes to the applicable law were made by the Tax Reform Act of 1986. These regulations affect corporate taxpayers and provide them with guidance necessary to determine their alternative minimum tax liability.

In addition, the text of the temporary regulations set forth in this document also serves as the text to the proposed regulations *** [LR-55-87, page 929, this Bulletin].

EFFECTIVE DATE: Taxable years beginning after December 31, 1986.

SUPPLEMENTARY INFORMATION

BACKGROUND

This document contains temporary regulations relating to the book income adjustment to the corporate alternative minimum taxable income of foreign corporations under section 56(c)(1) and section 56(f) of the Internal Revenue Code of 1986 (Code), as amended by section 701 of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2320). The temporary regulations provided by this document remain in effect until superseded by final regulations on these subjects.

These temporary regulations are intended to address only the issues raised by section 56 relating to the book income adjustment of foreign corporations. No inference should be drawn regarding issues not expressly addressed in the regulations. In addition, unless otherwise stated, no inference should be drawn from the issues addressed in these regulations to the determination of the book income adjustment by United States corporate taxpayers.

EXPLANATION OF PROVISIONS

In General

Section 882 of the Code, as amended by the Tax Reform Act of 1986, provides that for taxable years beginning after December 31, 1986, a foreign corporate taxpayer (foreign taxpayer) engaged in a trade or business in the United States during the taxable year shall be taxable as provided in section 55, relating to the alternative minimum tax, on its taxable income that is effectively connected with the conduct of a trade or business in the United States. Under section 56(c)(1) of the Code, a foreign taxpayer, when computing corporate alternative minimum taxable income for purposes of determining its alternative minimum tax for taxable years beginning in 1987, 1988, and 1989, must include an adjustment for the net book income of such taxpayer (the "book income adjustment").

Section 56(f)(1) provides that the book income adjustment is computed by increasing alternative minimum taxable income by 50 percent of the amount (if any) by which the adjusted net book income of the taxpayer exceeds alternative minimum taxable income for the taxable year (determined without regard to the book income adjustment and the alternative minimum tax net operating loss deduction). Adjusted net book income equals the net book income of the taxpayer shown on its applicable financial statement with certain adjustments. In general, a taxpayer's applicable financial statement is its financial statement that has the highest priority, determined in the following order: (a) a financial statement required to be filed with the Securities and Exchange Commission; (b) a certified auditied financial statement used for credit purposes, for disclosure to shareholders or for any other substantial non-tax purpose; (c) a financial statement (but not a tax return) that is required to be provided to the Federal government or an agency thereof, a state government or an agency thereof, or a political subdivision of a state or an agency thereof; or (d) any other financial statement used as a statement for credit purposes, for reporting to shareholders, or for any other substantial non-tax purpose (an unaudited financial statement). If a taxpayer does not have any financial statement, or only has an unaudited financial statement and makes an election, the book income adjustment is computed using current earnings and profits.

On April 28, 1987, the Federal Register (52 F.R. 15305) published temporary regulations under sections 56(c)(1) and (f) of the Code (T.D. 8138) [1987-1 C.B. 3] that provide guidance for computing the alternative minimum tax book income adjustment. Those temporary regulations did not address all issues relating to the computation of the book income adjustment by a foreign taxpayer. Section 1.56-1T(c)(5)(ii), relating to the applicable financial statement of a foreign taxpayer conducting a trade or business in the United States, was specifically reserved.

Net Book Income of a Foreign Taxpayer

Generally, §1.56-1T(b) of the temporary regulations, relating to the determination of net book income, is applicable in determining the net book income of a foreign taxpayer. However, §1.56-1T(b) is amended by these temporary regulations to provide that in the case of a foreign taxpayer net book income is limited to the income or loss reported on the applicable financial statement of the foreign taxpayer that is effectively connected with the conduct of a trade or business in the United States ("effectively connected net book income").

Effectively connected net book income includes book income or loss attributable to an item that would be treated as effectively connected under the principles of section 864(c), or any other applicable provision of the Code and the regulations thereunder. For example, if for tax purposes the disposition of a United States real property interest would be treated as effectively connected with a trade or business in the United States under section 897, then the book gain or loss attributable to such disposition would be treated as effectively connected net book income.

Effectively connected net book income does not include any amount of book income or loss attributable to an item that would qualify as effectively connected with the conduct of a trade or business in the United States under section 864(c) but for a specific exclusion in any provision of the Code. Consequently, effectively connected net book income does not include any amount attributable to exempt foreign trade income of a foreign sales corporation (FSC) that is treated as foreign source income that is not effectively connected with the conduct of a trade or business in the United States under section 921(a) and the regulations thereunder. However, dividends paid by a FSC may be includible in the net book income of the dividend recipient under the rules of §1.56-1T(b)(2)(iv) of the temporary regulations.

Effectively connected net book income also excludes any amount that is attributable to income that qualifies as effectively connected with the conduct of a trade or business in the United States but that is exempt from United States taxation under section 894 of the Code, relating to amounts exempt under the provision of a United States income tax treaty. In addition, effectively connected book income excludes amounts that are exempt from United States taxation under sections 883, 892 and 895 of the Code.

Section 1.56-1T(b)(5) provides that if a taxpayer does not have an applicable financial statement, or only has an unaudited financial statement and makes the election described in §1.56-1T(c)(2), net book income equals current earnings and profits for the taxable year. The temporary regulations are revised to provide that under these circumstances, a foreign taxpayer shall use effectively connected earnings and profits rather than current earnings and profits. Effectively connected earnings and profits are computed using the rules of section 884(d), relating to effectively connected earnings and profits for purposes of the branch profits tax. However, in computing effectively connected earnings and profits for purposes of the book income adjustment, the exceptions set forth under section 884(d)(2)(B) through (D) are not applicable.

Applicable Financial Statement of a Foreign Taxpayer

The rules set forth in §1.56-1T(c) of the temporary regulations, relating to the determination of the applicable financial statement for purposes of computing the book income adjustment, generally apply in determining the applicable financial statement of a foreign taxpayer conducting a trade or business in the United States. However, §1.56-1T(c)(5)(ii) is amended to provide special rules for determining the applicable financial statement of a foreign taxpayer.

Under §1.56-1T(c)(5)(ii), the applicable financial statement of a foreign taxpayer is the statement prepared by its United States trade or business that has the highest priority under §1.56-1T(c)(3). Section 1.56-1T(c)(1)(ii) is revised to provide that a statement will be a certified audited statement if it is certified to be fairly presented by either an independent Certified Public Accountant, or a similarly qualified professional in any foreign country. Section 1.56-1T(c)(5)(ii)(B)(*1*) clarifies that an applicable financial statement of a foreign taxpayer may be prepared under the generally accepted accounting principles of a foreign country. However, under §1.56-1T(c)(5)(ii)(B)(*2*), a financial statement must be prepared in United States dollars to be considered as an applicable financial statement.

Section 1.56-1T(c)(5)(ii)(C) provides special priority rules if a foreign taxpayer has more than one financial statement of equal priority. Under §1.56-1T(c)(5)(ii)(C)(*1*), the applicable financial statement of a foreign taxpayer that has more than one financial statement of equal priority reporting on the same United States trades or businesses is the financial statement that reports the greatest amount of adjusted net book income. If, however, the financial statements report on different trades or businesses, §1.56-1T(c)(5)(ii)(C)(*2*) provides that the applicable financial statement is that financial statement reflecting the greatest amount of gross receipts attributable to United States trades or businesses. If after applying §1.56-1T(c)(5)(ii)(C)(*2*) the taxpayer still has financial statements of equal priority, the applicable financial statement is that financial statement resulting in the greatest amount of adjusted book income.

If a United States trade or business of a foreign taxpayer modifies its financial reporting and the principal purpose of such action is to reduce adjusted net book income, §1.56-1T(c)(5)(ii)(D) provides that the District Director may, based on all the facts and circumstances, determine the taxpayer's applicable financial statement.

Adjustments to Net Book Income of a Foreign Taxpayer

The rules of §1.56-1T(d) of the temporary regulations, relating to adjustments to net book income, apply when determining the net book income adjustment of a foreign taxpayer. However, a new §1.56-1T(d)(7) is added to provide for special adjustments to net book income for foreign taxpayers. These rules require a foreign taxpayer to include any effectively connected net book income of the foreign taxpayer that is not reported on the applicable financial statement, and to exclude any amount reported on the applicable financial statement that is not treated as effectively connected net book income. For example, if the applicable financial statement of a foreign taxpayer only reports on one of its two businesses conducted in the United States, the effectively connected net book income amount reported on the applicable financial statement must be adjusted to include amounts attributable to income effectively connected to the operation of the other business in the United States.

SPECIAL ANALYSES

No general notice of proposed rulemaking is required by 5 U.S.C. 553(b) for temporary regulations. Accordingly, the Regulatory Flexibility Act does not apply, and no Regulatory Flexibility Analysis is required for this rule. The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

* * * * *

Adoption of amendments to the regulation

Accordingly 26 CFR Part 1 is amended as follows:

Paragraph 1. The authority for Part 1 continues to read in part:

Authority: 26 U.S.C. 7805 *** Section 1.56-1T is also issued under 26 U.S.C. 56(f)(2)(H).

Par. 2. Section 1.56-0T is amended as follows:

1. Item (b)(6) is redesignated as (b)(7).

2. A new (b)(6) is added immediately after item (b)(5)(ii) to read as set forth below.

3. Item (c)(5)(ii) is amended by adding (A) through (C) to read as set forth below.

4. A new item (d)(7) is added immediately after item (d)(6) to read as set forth below.

§1.56-0T Table of contents to §1.56-1T, adjustment for book income of corporations (temporary)

* * * * *

(b) Adjusted net book income ***
  (6) Additional rules for computation of net book income of a foreign corporate taxpayer.
    (i) Adjusted net book income of a foreign taxpayer.
    (ii) Effectively connected net book income of a foreign taxpayer.
      (A) In general.
      (B) Certain exempt amounts.
    (iii) Computation of net book income of a foreign taxpayer using current earnings and profits.

* * *

(c) Applicable financial statement. ***
  (5) Special rules. ***
    (ii) Applicable financial statement of a foreign

taxpayer with a United States trade or business.
- (A) In general.
- (B) Special rules for applicable financial statement of a trade or business of a foreign taxpayer.
- (C) Special rule for statements of equal priority.
- (D) Anti-abuse rule.

* * *

(d) Adjustments to net book income. ***

(7) Adjustments for foreign taxpayers with a United States trade or business.
- (i) In general.
- (ii) Example.

Par. 3. Section 1.56–1T is amended as follows:

1. In the last sentence of paragraph (b)(2)(iv), the phrase "(3) and (4)" is revised to read "(3), (4) and (9)".

2. Paragraph (b)(6) is redesignated paragraph (b)(7).

3. References to paragraph (b)(6) in the last sentence of paragraph (b)(2)(iii), the last sentence of (b)(2)(iv), the last sentence of paragraph (b)(4)(i), the second sentence of paragraph (b)(4)(iii), and the second sentence of paragraph (b)(iv) are revised to read "paragraph (b)(7)".

4. A new paragraph (b)(6) is added to read as set forth below.

5. In redesignated paragraph (b)(7), Examples (9) through (14) are added to read as set forth below.

6. The second sentence of paragraph (c)(1)(ii) is revised as set forth below.

7. In the last sentence of paragraph (c)(4), the phrase "(4) and (5)" is revised to read "(4), (5), (19) and (20)".

8. The text for Paragraph (c)(5)(ii) is added.

9. In paragraph (c)(6), Examples (15) through (21) are added to read as set forth below.

10. A new paragraph (d)(7) is added to read as set forth below.

§1.56–1T Adjustment for the book income of corporations (temporary)

* * * * *

(b) *Adjusted net book income* ***

(6) *Additional rules for computation of net book income of a foreign corporate taxpayer*—(i) *Adjusted net book income of a foreign taxpayer.* Adjusted net book income of a foreign corporate taxpayer ("foreign taxpayer") means the effectively connected net book income (as defined in paragraph (b)(6)(ii) of this section) of the foreign taxpayer, after taking into account the adjustments under the rules of paragraph (d) of this section.

(ii) *Effectively connected net book income of a foreign taxpayer*—(A) *In general.* Effectively connected net book income of a foreign taxpayer is the income or loss reported in its applicable financial statement (as defined in paragraph (c)(5)(ii) of this section), but only to the extent that such amount is attributable to items of income or loss that would be treated as effectively connected with the conduct of a trade or business in the United States by the foreign taxpayer as determined under either the principles of section 864(c) and the regulations thereunder, or any other applicable provision of the Internal Revenue Code of 1986. Thus, if for tax purposes an item of income or loss is treated as effectively connected with the conduct of a trade or business in the United States, then the income or loss reported on the foreign taxpayer's applicable financial statement attributable to such item is effectively connected net book income. See paragraph (b)(7), Examples (10), (11) and (12) of this section.

(B) *Certain exempt amounts.* Effectively connected net book income does not include any amount attributable to an item that is exempt from United States taxation under sections 894, 883, 892 or 895 of the Internal Revenue Code of 1986. See paragraph (b)(7), Examples (13) and (14) of this section.

(iii) *Computation of net book income of a foreign taxpayer using current earnings and profits.* If a foreign taxpayer does not have an applicable financial statement or only has a statement described in paragraph (c)(1)(iv) of this section and makes the election described in paragraph (c)(2) of this section, net book income for purposes of this section is equal to the foreign taxpayer's current earnings and profits that are attributable to income or loss that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States. Effectively connected current earnings and profits are computed under the rules of section 884(d) and the regulations thereunder, relating to effectively connected earnings and profits for purposes of computing the branch profits tax, but without regard to the exceptions set forth under section 884(d)(2)(B) through (D). For purposes of this section, effectively connected current earnings and profits are not reduced by any remittances or distributions. Effectively connected current earnings and profits take into account Federal income tax expense and any foreign tax expense; however, see paragraph (d)(3) of this section for adjustments to net book income with respect to certain taxes.

(7) *Examples.* ***

Example (9). Corporation I is a United States corporation with a 100 percent owned subsidiary, J, a foreign sales corporation (FSC). I uses a calendar year for both financial accounting and tax purposes. Income from J is consolidated in I's applicable financial statement. I and J do not file a consolidated tax return. In 1987, J pays a dividend to I of $100 out of J's earnings and profits. For purposes of this example, it is assumed that the distribution is made out of the profits attributable solely to foreign trade income determined through use of the administrative pricing rules of section 925(a)(1) and (2). Accordingly, the distribution is eligible for the 100 percent dividends received deduction under section 245(c). Although I's applicable financial statement is adjusted to eliminate income or loss attributable to J, the entire amount of the dividend distribution must be included in I's adjusted net book income pursuant to paragraph (b)(2)(iv) of this section.

Example (10). Corporation K is a foreign corporation incorporated under the laws of country X. K uses a calendar year for both financial accounting and tax purposes. In 1987, K actively conducts a real estate business, L, in the United States. The financial statement that is used as K's applicable financial statement (as determined under paragraph (c)(5)(ii) of this section) discloses total net income of $150. Of this amount, $100 is attributable to L's real estate business. $50 is attributable to dividends paid to L from its investment in certain securities. The securities investment is not connected with L's real estate business. Under the rules of section 864, only $100 is effectively connected to the conduct of a trade or business in the United States. Thus, K's effectively connected net book income for 1987 equals $100.

Example (11). Assume the same facts as in Example (10) except that K's applicable financial statement also discloses $75 attributable to investment real property located in the United States, so that the net income amount reported on the financial statement equals $225. The $75 of income is not effectively connected with the conduct of a trade or business in the United States. K, for regular tax purposes, makes an election under section 882(d) to treat this income as effectively connected with the conduct of a trade or business in the United States. As a result, K's effectively connected net book income for 1987 equals $175 ($100 + $75).

Example (12). Corporation M is a foreign corporation that actively conducts a manufacturing business, N, in the United States. M is a calendar year taxpayer for both financial accounting and tax purposes. In 1987, the financial statement that is used as M's applicable financial statement (as determined under paragraph (c)(5)(ii) of this section) reflects an anticipated loss from the sale of a division of N. For Federal income tax purposes the loss is not recognized in 1987, but rather is recognized in 1988 when M sells the division. In determining M's effectively connected net book income for 1987, the anticipated loss reported on M's 1987 applicable financial statement is taken into account because the reported loss is effectively connected to the conduct of a trade or business in the United States under the principles of section 864.

Example (13). Corporation O is a foreign corporation that is engaged in the international shipping business. O is incorporated under the laws of X. O is a calendar year taxpayer for both financial accounting and tax purposes. In 1987, O actively conducts a shipping business, P, within the United States. The statement that is used in 1987 as O's applicable financial statement (as determined under paragraph (c)(5)(ii) of this section) discloses income of $100 that is attributable to P's operation of ships in international traffic. Under section 864, $50 is effectively connected with the conduct of a trade or business in the United States. However, the United States income tax treaty with X exempts from United States income tax any income derived by a resident of X from the operation of ships in international traffic. Thus, pursuant to paragraph (b)(6)(ii)(B) of this section, no amount of P's income is includible in O's effectively connected net book income.

Example (14). Assume the same facts as in Example (13) except that there is no United States income tax treaty with X. However, X by statute exempts United States citizens and United States corporations from tax imposed by X on gross income derived from the operation of a ship or ships in international traffic. Under section 883(a), P's income of $50 that is effectively connected with the conduct of a trade or business in the United States is exempt from United States taxation. Thus, pursuant to paragraph (b)(6)(ii)(B)(*2*) of this section, no amount of P's income is includible in O's effectively connected net book income.

(c) *Applicable financial statement.* (1) *In general.* ***

(ii) *Certified audited financial statement.* A certified audited financial statement that is used for credit purposes, for reporting to shareholders or for any other substantial non-tax purpose. Such statement must be certified by a Certified Public Accountant or a similarly qualified professional who is licensed in any foreign country and who is independent, as defined in the American Institute of Certified Public Accountants Professional Standards, Code of Ethics (ET), Section 101, or other similar standard in accordance with the standards of the profession in any foreign country. ***

* * * * *

(5) *Special rules.* ***

(ii) *Applicable financial statement of a foreign taxpayer with a United States trade or business*—(A) *In general.* The applicable financial statement of a foreign taxpayer conducting one or more trades or businesses in the United States is the financial statement prepared by any such trade or business (or attributable to more than one such trades or businesses) that has the highest priority as determined under paragraph (c)(3) of this section. See paragraph (c)(6), Example (15) of this section.

(B) *Special rules for applicable financial statement of a trade or business of a foreign taxpayer*—(*1*) *Financial statement prepared under foreign generally accepted accounting principles.* Subject to the rules of this section, a financial statement prepared by a United States trade or business using generally accepted accounting principles of a foreign country may be an applicable financial statement under this paragraph (c). See paragraph (c)(6), Example (16) of this section.

(*2*) *Financial statement prepared in United States dollars.* Except as provided in paragraph (c)(5)(ii)(D) of this section, the financial statement of a United States trade or business must be prepared in United States dollars in order to be considered the applicable financial statement of the foreign taxpayer under this paragraph (c). See paragraph (c)(6), Example (17) of this section.

(C) *Special rule for statements of equal priority.* If a foreign taxpayer has two or more financial statements of equal priority (determined under paragraphs (c)(3)(i) and (c)(3)(ii) of this section and this paragraph (c)(5)(ii)), the foreign taxpayer's applicable financial statement is determined under either paragraph (c)(5)(ii)(C)(*1*) or (*2*) of this section, whichever is applicable.

(*1*) *Two or more financial statements reporting on the same trades or businesses.* If two or more financial statements of equal priority report on the same United States trades or businesses, the applicable financial statement of the foreign taxpayer is determined under the rule of paragraph (c)(3)(iii) of this section. In applying this rule, adjusted net book income (as defined under paragraph (b)(6)(ii)(A) of this section) shall be used. Thus, the financial statement that results in the greatest amount of adjusted net book income is the foreign taxpayer's applicable financial statement.

(*2*) *Two or more financial statements reporting on different trades or businesses.* If two or more financial statements of equal priority report on different United States trades or businesses, the foreign taxpayer's applicable financial statement is—

(*i*) The financial statement that reflects the greatest amount of gross receipts attributable to United States trades or businesses, or

(*ii*) If after applying the rules of paragraph (c)(5)(ii)(C)(*2*)(*i*) of this section, the foreign taxpayer still has financial statements of equal priority, the rules of paragraph (c)(3)(iii) of this section apply (using effectively connected adjusted net book income).

See paragraph (c)(6), Example (18) of this section.

(D) *Anti-abuse rule.* The special rules of this paragraph (c)(5)(ii) will not apply if a trade or business conducted in the United States by a foreign taxpayer modifies its financial reporting and the principal purpose of such action is to reduce the amount of the book income adjustment. In such cases, the District Director may, based upon all the facts and circumstances, determine the taxpayer's applicable financial statement. See paragraph (c)(6), Example (21), of this section.

(6) *Examples.* ***

Example (15). Corporation U is a foreign corporation incorporated in A. U is a calendar year taxpayer for both financial accounting and tax purposes. U actively conducts three real estate businesses, X, Y and Z, in the United States. In 1987, X prepares a certified audited financial statement that it provides to its United States creditor. In addition, in 1987, X, Y and Z each prepares unaudited financial statements that they provide to U for incorporation in U's worldwide financial statement. Under paragraph (c)(5)(ii)(A) of this section, U's applicable financial statement is the certified audited financial statement prepared by X. However, pursuant to paragraph (d)(7) of this section, an adjustment is required to include any of U's effectively connected net book income that is not included in X's certified audited financial statement (*e.g.*, the effectively connected net book income attributable to Y and Z).

Example (16). Corporation A is a foreign corporation incorporated in Z. A is a calendar year taxpayer for both financial accounting and tax purposes. A actively conducts a real estate business, B, in the United States. B prepares a certified audited financial statement for 1987 using the accounting principles of Z that it provides to A for incorporation into A's worldwide financial statement. In addition, B prepares a review statement for 1987 using United States generally accepted accounting principles that it provides to its United States creditors. Under paragraphs (c)(5)(ii)(A) and (c)(5)(ii)(B)(*1*) of this section, the financial statement prepared under the accounting principles of Z is the applicable financial statement.

Example (17). Assume the same facts as in Example (16) except that amounts are reported on B's certified audited financial statement in the currency of Z and amounts are reported on B's review statement in United States dollars. Since the review statement is prepared in United States dollars, under paragraph (c)(5)(ii)(B)(*2*) of this section, it is the applicable financial statement.

Example (18). Corporation C is a foreign corporation incorporated in Z. C is a calendar year taxpayer for both financial accounting and tax purposes. C actively conducts two real estate businesses, D and E, in the United States. D and E each separately prepare a certified audited financial statement for 1987 that they provide to their United States creditors. D's financial statement reports gross receipts of $100. E's financial statement reports gross receipts of $200. Under paragraph (c)(5)(ii)(C)(*2*) of this section, E's certified audited financial statement is the applicable financial statement and must be adjusted under the rules of paragraph (d)(7) of this section to include effectively connected book income attributable to D.

Example (19). F is a foreign corporation incorporated in X. F is a calendar year taxpayer for both financial accounting and tax purposes. F actively conducts a banking business, G, in the United States. G has been engaged in business in the United States since 1977. For the years 1977 through 1986, G did not prepare a separate financial statement. However, each year G provided F with its books, records and other raw financial data. F used this data in preparing its worldwide financial statement. G provides F with its 1987 books and records on January 5, 1988, in accordance with its historic practice. On February 15, 1988, G prepares an unaudited financial statement for calendar year 1987 that it provides to F. The principal purpose of creating this financial statement is to reduce net book income. Under these facts, the financial statement provided by G is not intended to be reasonably relied upon by F in preparing its worldwide financial statement. Therefore, for purposes of computing net book income, G's financial statement has not been used for a substantial non-tax purpose.

Example (20). Assume the same facts as in Example (19) except that for purposes of preparing F's 1987 worldwide financial statement, G does not provide F with any raw financial data, and G only provides F with an audited financial statement that is prepared for a substantial non-tax purpose. Under these facts, the financial statement provided by G is intended to be relied upon by F in preparing its worldwide financial statement. Therefore, for purposes of computing net book income, G's financial statement has been used for a substantial non-tax purpose.

Example (21). Corporation H is a foreign corporation incorporated in I. H is a calendar year taxpayer for both financial accounting and tax purposes. H actively conducts a real estate business, J, in the United States. For the years 1976 through 1986, J prepared a certified audited financial statement using United States dollars that it provided to H. In 1987, J prepares a certified audited financial statement using the currency of I. The principal purpose of the modification of J's financial reporting is to reduce the amount of the book income adjustment. Given these facts, the District Director may determine that J's 1987 certified audited financial statement prepared in the currency of I is J's applicable financial statement for 1987, and such statement must be converted into United States dollars based upon the translation used to prepare the certified audited financial statement in the currency of I. Accordingly, the effectively connected net book income of J for 1987 is the effectively connected net book income reported on the financial statement that has been converted into United States dollars.

(d) *Adjustments to net book income.*

* * * * *

(7) *Adjustments for foreign taxpayers with a United States trade or business*—(i) *In general.* Pursuant to paragraph (b)(6) of this section, the book income adjustment with respect to a foreign taxpayer with a United States trade or business is computed based on the effectively connected net book income of the foreign taxpayer (as defined in paragraph (b)(6)(ii) of this section). The net book income amount reported on the applicable financial statement of the foreign taxpayer (as determined under paragraph (c)(5)(ii) of this section) must be adjusted to—

(A) Include effectively connected net book income attributable to a trade or business conducted in the United States by the foreign taxpayer that is not reported on the applicable financial statement. Such amounts shall be determined from a financial statement (determined under paragraph (c) of this section and adjusted under the rules of this paragraph (d)) that would have qualified as an applicable financial statement of such excluded trade or business or upon effectively connected earnings and profits (if the rules of section (b)(6)(iii) of this section apply), and

(B) Exclude any amount reported on such applicable financial statement that does not qualify as effectively connected net book income.

See paragraph (d)(7)(ii), Example (1) of this section.

(ii) *Example.* The provisions of this paragraph may be illustrated by the following example.

Example. Foreign corporation A a calendar year taxpayer for financial accounting and tax purposes, is incorporated in X. A actively conducts two real estate businesses, B and C, in the United States. B prepares a certified audited financial statement that it provides to its United States creditor. C does not prepare a financial statement. The certified audited financial statement prepared by B is treated as A's applicable financial statement under paragraph (c)(5)(ii) of this section. B's certified audited financial statement, in addition to amounts related to the conduct of its real estate business, also reports income received from its investment in United States securities, unrelated to its conduct of business in the United States that does not qualify as effectively connected net book income. In order to determine A's effectively connected net book income from the net book income reported on the applicable financial statement, such statement must be adjusted to exclude amounts attributable to the securities. In addition, book income or loss attributable to C, to the extent effectively connected to its business in the United States, must be included in the effectively connected net book income reported on B's financial statement. Since C does not have a financial statement, C's effectively connected net book income is determined by computing its effectively connected earnings and profits under paragraph (b)(6)(iii) of this section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved April 14, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 27, 1988, 8:45 a.m., and published in the issue of the Federal Register for April 28, 1988, 53 F.R. 15200)

Subchapter B.—Computation of Taxable Income
Part I.—Definition of Gross Income, Adjusted Gross Income, Taxable Income, etc.

Section 61.—Gross Income Defined

26 CFR 1.61-2T: Taxation of fringe benefits.

Fringe benefits; aircraft valuation formula. For purposes of section 1.61-2T(g) of the temporary regulations, relating to the rule for valuing noncommercial flights on employer-provided aircraft, the Standard Industry Fare Level (SIFL) cents-per-mile rates and the terminal charges in effect on December 31, 1987, and for prior periods are set forth. Rev. Rul. 87-101 superseded.

Rev. Rul. 88-40

For purposes of the taxation of fringe benefits under section 61 of the Internal Revenue Code, section 1.61-2T(g) of the Temporary Income Regulations provides a rule for valuing noncommercial flights on employer-provided aircraft. Section 1.61-2T(g)(5) of the temporary regulations sets forth an aircraft valuation formula to determine the value of such flights. The value of a flight is determined under the base aircraft valuation formula (also known as the Standard Industry Fare Level formula or SIFL) by multiplying the SIFL cents-per-mile rates applicable for the period during which the flight was taken by the appropriate aircraft multiple provided in section 1.61-2T(g)(7) and then adding the applicable terminal charge. The value of a particular flight during the first 6 months of a calendar year is determined by using the SIFL rates and terminal charge in effect on December 31 of the preceding year. The value of a particular flight during the last 6 months of a calendar year is determined by using the SIFL rates and terminal charge in effect on June 30 of that year.

Therefore, to determine the value of a noncommercial flight taken on an employer-provided aircraft during the first six months of 1988 for purposes of section 1.61-2T(g), the applicable terminal charge and SIFL rates are those in effect on December 31, 1987.

The terminal charge in effect on December 31, 1987, is $25.20 and the SIFL rates in effect on December 31, 1987, are $.1378 per mile for the first 500 miles, $.1051 per mile for 501 through 1500 miles, and $.1010 per mile for miles over 1500.

The following chart sets forth the cumulative terminal charges and SIFL mileage rates:

Period	*Terminal Charge*	*SIFL Mileage Rates*
1/1/85-6/30/85	$27.05	Up to 500 miles = $.1480 per mile 501-1500 miles = $.1128 per mile Over 1500 miles = $.1085 per mile
7/1/85-12/31/85	$25.62	Up to 500 miles = $.1402 per mile 501-1500 miles = $.1069 per mile Over 1500 miles = $.1028 per mile
1/1/86-6/30/86	$26.19	Up to 500 miles = $.1433 per mile 501-1500 miles = $.1092 per mile Over 1500 miles = $.1050 per mile
7/1/86-12/31/86	$26.02	Up to 500 miles = $.1423 per mile 501-1500 miles = $.1085 per mile Over 1500 miles = $.1043 per mile
1/1/87-6/30/87	$23.80	Up to 500 miles = $.1302 per mile 501-1500 miles = $.0993 per mile Over 1500 miles = $.0954 per mile
7/1/87-12/31/87	$23.95	Up to 500 miles = $.1310 per mile 501-1500 miles = $.0999 per mile Over 1500 miles = $.0960 per mile
1/1/88-6/30/88	$25.20	Up to 500 miles = $.1378 per mile 501-1500 miles = $.1051 per mile Over 1500 miles = $.1010 per mile

EFFECT ON OTHER REVENUE RULING

Rev. Rul. 87-101, 1987-2 C.B. 42, is superseded.

Section 67.—2-Percent Floor on Miscellaneous Itemized Deductions

26 CFR 1.67-1T: 2-percent floor on miscellaneous itemized deductions (temporary).

T.D. 8189

TITLE 26—INTERNAL REVENUE.—
CHAPTER 1, SUBCHAPTER A,
PART 1—INCOME TAX; TAXABLE
YEARS BEGINNING AFTER
DECEMBER 31, 1953; PART 602.—
OMB CONTROL NUMBERS UNDER
THE PAPERWORK REDUCTION
ACT

2-Percent Floor on Miscellaneous Itemized Deductions

AGENCY: Internal Revenue Service, Treasury

ACTION: Final and temporary regulations.

SUMMARY: This document provides temporary regulations under new section 67 of the Internal Revenue Code relating to the 2-percent floor on miscellaneous itemized deductions. The text to the temporary regulations set forth in this document also serves as the text of proposed regulations cross-referenced in the notice of proposed rulemaking *** [LR 97-86, page 923, this Bulletin]

DATES: The regulations apply to taxable years beginning after December 31, 1986.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains temporary Income Tax Regulations under section 132 of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2113). That section added new section 67 to the Internal Revenue Code. Section 67(c) directs that regulations be issued relating to the indirect deduction through pass-through entities of amounts for expenses that would be subject to the 2-percent floor on miscellaneous itemized deductions if paid or incurred directly by an individual. In addition section 67(c) directs that regulations be issued relating to the reporting requirements that are necessary to carry out the purposes of the section.

These temporary regulations are issued under the authority contained in Internal Revenue Code sections 67(c) and 7805 (100 Stat. 2114, 26 U.S.C. 67(c); 68A Stat. 917, 26 U.S.C. 7805, respectively).

2-PERCENT FLOOR ON MISCELLANEOUS ITEMIZED DEDUCTIONS

Pursuant to section 67 of the Code, §1.67-1T(a)(1) of the temporary regulations disallows deductions for miscellaneous itemized deductions in computing the taxable income of individuals (i.e., so-called "below-the-line" deductions) to the extent that the aggregate of such expenses does not exceed 2 percent of the individual's adjusted gross income. Examples of expenses that, if otherwise deductible, are subject to the 2-percent floor include unreimbursed employee business expenses, expenses for the production or collection of income such as investment advisory fees and the cost of safe deposit boxes, and expenses for tax advice. To the extent that any other limitation is placed on the amount of a miscellaneous deduction, that limitation generally applies prior to the application of the 2-percent floor. For example, pursuant to section 274(n) the amount allowable as a deduction for meal and entertainment expenses cannot exceed 80 percent of the amount of such expense that is otherwise deductible. The 2-percent floor is applied to the amount allowable after application of the 80-percent limitation.

The term "miscellaneous itemized deduction" means the deductions allowable from adjusted gross income in determining taxable income other than the deductions listed in §1.67-1T(b) of the temporary regulations, such as the deductions under sections 163, 164, and 217 relating to interest, taxes, and moving expenses, respectively.

Temporary §1.67-1T(c) provides that, if a taxpayer incurs expenses that relate to both a trade or business activity and production of income or tax preparation activity, the taxpayer shall allocate such expense between the activities on a reasonable basis.

MEMBERS OF CONGRESS

Section 1.67-1T(d) of the temporary regulations provides that the 2-percent floor is applied prior to the application of the $3,000 limitation on deductions for living expenses of Members of Congress referred to in section 162(a). The amount of miscellaneous itemized deductions of a Member of Congress that is disallowed because of the 2-percent floor is allocated between deductions for living expenses (within the meaning of section 162(a)) and other miscellaneous itemized deductions of a Member of Congress.

REIMBURSED AND UNREIMBURSED EMPLOYEE EXPENSES

Temporary §1.62-1T(e)(1) provides that expenses paid or incurred by an employee that are otherwise deductible from gross income in computing taxable income and for which the employee is reimbursed by the employer, its agent, or third party (for whom the employee performs a benefit as an employee of the employer) under an express agreement for reimbursement or pursuant to an express expense allowance arrangement may be deducted from gross income in computing adjusted gross income (i.e., so-called "above-the-line" deductions). The same rules apply with respect to amounts allowable as a deduction under section 162(h)(1)(B) to state legislators that are reimbursed by the state.

Section 1.62-1T(e)(1) of the temporary regulations provides generally that, if an employee is reimbursed by his or her employer, its agent, or a third party in an amount less than the total expenses paid or incurred by the employee, the determination of to which of the employee's business expenses the reimbursement applies and the amount of each expense that is covered by the reimbursement is made on the basis of all of the facts and circumstances of the particular case. Section 1.62-1T(e)(2) of the temporary regulations provides rules for allocating reimbursements between meal and entertainment expenses and other business expenses when the facts and circumstances are not clear and the employee pays or incurs meal or entertainment expenses. Section 274(n)(2) excepts from the 80-percent limitation contained in section 274(n), by cross-reference to section 274(e)(3), expenses paid or incurred by an employee, in connection with the performance by the employee of services for the employer, under a reimbursement or other expense allowance arrangement with the employer, but only to the extent the employer does not treat such expenses under section 274(e)(2) as compensation to the employee and as wages for purposes of withholding. In this situation the 80-percent limitation applies to the employer.

For taxable years beginning after December 31, 1986, any portion of the amount allowable to state legislators as a deduction pursuant to section 162(h)(1)(B) that is not reimbursed by the state or a third party is allocated among expenses for lodging, meals, and incidental expenses in the manner described in §1.62-1T(e)(4) of the temporary regulations.

Temporary §1.62-1T(f) defines the phrase "reimbursement or other expense allowance arrangement." In addition, a payment under a reimbursement or other expense allowance arrangement must be identified either by making a separate payment or by specifically indicating the separate amount if both wages and the reimbursement or expense allowance are combined in a single payment. It shall be presumed that any amounts treated as compensation to an employee by an employer on the employer's return of tax under chapter 1 of the Code and as wages to such employee for purposes of chapter 24 of the Code (relating to withholding of income tax at source of wages) do not constitute reimbursements or other expense allowances for purposes of section 62. This presumption may be rebutted by clear and convincing evidence to the contrary that includes evidence of an obligation by the employee to make an adequate accounting to the employer for the employee's business expenses.

TREATMENT OF PASS-THROUGH ENTITIES

Temporary §1.67-2T provides rules for the application of section 67 to holders of interests in pass-through entities. In general, an "affected investor" in a pass-through entity is required to separately take into account as an item of both income and expense an amount equal to his or her allocable share of the "affected expenses" of the pass-through entity for purposes of determining his or her taxable income. In general, the expenses so taken into account are treated as paid or incurred by the affected investor in the same manner as paid or incurred by the pass-through entity.

A pass-through entity includes, pursuant to temporary §1.67-2T(g), a grantor trust, a partnership, an S corporation, a common trust fund, a nonpublicly offered regulated investment company, and a real estate mortgage investment conduit (REMIC). It does not include an estate, a nongrantor trust, a cooperative, a real estate investment trust, or other entities such as a qualified pension plan, an individual retirement account, or an insurance company holding assets in a separate asset account to fund certain variable contracts.

Section 1.67-2T(b) of the temporary regulations provides rules for the application of section 67 to affected investors in partnerships, S corporations, and grantor trusts and temporary §1.67-2T(d) provides such rules for affected investors in common trust funds. In addition, section 1.67-2T(c) of the temporary regulations cross-references temporary §1.67-3T for rules regarding the application of section 67 to holders of interests in REMICs. Temporary §1.67-2T(p) reserves on the rules regarding publicly offered regulated investment companies. The rules for the application of section 67 to REMICs, estates, and nongrantor trusts are the subject of separate regulations projects. The application of section 67 to estates and trusts and their beneficiaries is the subject of pending technical corrections legislation. Guidance on this issue will be published separately.

The application of section 67 to affected investors that are shareholders in a nonpublicly offered regulated investment company is described in temporary §1.67-2T(e). In general, an affected investor shall be treated both as having received or accrued a dividend and as having paid or incurred an expense described in section 212. The amount of the dividend and the amount of the expense are each equal to the affected investor's allocable share of the affected RIC expenses of the nonpublicly offered regulated investment company. The affected investor shall take into account such amounts in the affected investor's taxable year with which (or within which) the calendar year with respect to which the expenses are allocated ends. A shareholder of a nonpublicly offered regulated investment company that is not an affected investor does not take into account in computing its taxable income any amount of its allocable share of affected RIC expenses.

DEFINITIONS OF CERTAIN TERMS

The term "affected investor" generally means a partner, shareholder, beneficiary, participant (or other interest holder in a pass-through entity), that is (a) an individual (other than certain nonresident aliens), (b) a person that computes its taxable income in the same manner as in the case of an individual, or (c) a pass-through entity, interests in which are owned by affected investors.

In general, the term "affected expenses" means expenses that, if paid or incurred by an individual, would be deductible, if at all, as miscellaneous itemized deductions. In the case of a nonpublicly offered regulated investment company, the term "affected expenses" means only affected RIC expenses. Temporary §1.67-2T(j)(1) generally defines the term "affected RIC expenses" as the excess of (a) the aggregate amount of the expenses paid or incurred in the calendar year that are allowable as a deduction in determining the investment company taxable income (without regard to section 852(b)(2)(D)) of the nonpublicly offered regulated investment company for a taxable year that begins or ends with or within the calendar year, over (b) certain expenses, such as registration fees, directors' or trustees' fees, transfer agent fees, and certain legal and accounting fees. For this purpose deductions described in section 62(a)(3) and §1.67-1T(b) (e.g., losses from the sale or exchange of property, taxes, and interest) are excluded. A nonpublicly offered regulated investment company must determine the amount of affected RIC expenses on a calendar year basis regardless of whether its taxable year is the calendar year.

Section 1.67-2T(j)(2) of the temporary regulations provides an elective safe harbor under which a nonpublicly offered regulated investment company may treat 40 percent of certain deductions for the calendar year as its affected RIC expenses for that year. The election once made remains in effect for each succeeding calendar year unless revoked with the consent of the Commissioner.

ALLOCATION OF EXPENSES BY NONPUBLICLY OFFERED REGULATED INVESTMENT COMPANIES

A nonpublicly offered regulated investment company is required to allocate to each of its affected investors that is a shareholder at any time during the calendar year the affected investor's allocable share of the affected RIC expenses of the nonpublicly offered regulated investment company for that calendar year. (This allocable share is the amount that the affected shareholder is treated as having received or accrued as a dividend and paid or incurred as an expense described in section 212.) A nonpublicly offered regulated investment company may use any reasonable method to make the allocation. Temporary §1.67-2T(k)(1) provides that an allocation method shall not be reasonable if, for example, it can be expected to have the effect (a) of allocating to the shareholders an amount of affected RIC expenses that is less than the affected RIC expenses of the nonpublicly offered regulated investment company for the calendar year or (b) of allocating a disproportionately high share of the affected RIC expenses of the nonpublicly offered regulated investment company to either (1) shareholders that are not affected investors, or (2) affected investors, the amount of whose miscellaneous itemized deductions exceed the 2-percent floor described in section 67.

Section 1.67-2T(k)(2) of the temporary regulations describes a reasonable allocation method. In general, under this method an affected investor's allocable share of the affected RIC expenses of a nonpublicly offered regulated investment company is the amount that bears the same ratio to the amount of affected RIC expenses of the nonpublicly offered regulated investment company for the calendar year as the amount of dividends paid to the affected investor during the calendar year bears to the sum of (a) the aggregate amount of dividends paid by the nonpublicly offered regulated investment company during the calendar year to all shareholders and (b) any amount on which tax is imposed under section 852(b)(1) for any taxable year of the nonpublicly offered regulated investment company ending within or with the calendar year. If a nonpublicly offered regulated investment company does not make a reasonable allocation of affected RIC expenses to its affected investors, a reasonable allocation shall be made by an appropriate District Director.

SPECIAL RULES

The amount of dividend income that an affected investor is treated as receiving as a result of an allocation of affected RIC expenses is not subject to backup withholding under section 3406.

Temporary §1.67-2T(m) describes persons who may, for certain purposes, treat an affected investor's allocable share of the affected RIC expenses of a nonpublicly offered regulated investment company as being an amount determined on the basis of a reasonable estimate published by the nonpublicly offered regulated investment company in a widely available financial publication (e.g., *Wall Street Journal or Standard and Poor's Weekly Dividend Record).* For example, a nominee who is required to report dividends paid by a nonpublicly offered regulated investment company to the Internal Revenue Service and to the person to whom the payment is made may rely on the estimate for purposes of such reporting. In addition, the affected investor to which the nominee reports may rely on the estimate for purposes of calculating its taxable income and the amount of its affected expenses.

REPORTING REQUIREMENTS

If a nonpublicly offered regulated investment company is required to make an information return to the Internal Revenue Service pursuant to section 6042 (or would be required to make such a return but for the $10 threshold described in section 6042(a)(1)(A) and (B)) with respect to an affected investor to which an allocation of affected RIC expenses is required to be made, the nonpublicly offered regulated investment shall report to the Internal Revenue Service the amount of affected RIC expenses required to be allocated to the affected investor for the calendar year, as well as certain other information. Temporary §1.67-2T(n)(1)(ii) requires a nonpublicly offered regulated investment company to provide to each affected investor for each calendar year (whether or not the nonpublicly offered regulated investment company is required to make an information return with respect to the affected investor pursuant to section 6042), a written statement that includes the amount of affected RIC expenses required to be allocated to the affected investor for the calendar year and certain other information. If an affected investor's shares in a nonpublicly offered regulated investment company are held in the name of a nominee, the nonpublicly offered regulated investment company may make the information return with respect to the nominee and provide the written statement to the nominee. Section 1.67-2T(n)(2) of the temporary regulations provides reporting requirements for nominees to which a nonpublicly offered regulated investment company provides a written statement. These requirements are similar to the ones with which regulated investment companies must comply.

Pursuant to temporary §1.67-2T(n)(5), a nonpublicly offered regulated investment company or a nominee fulfills its reporting obligations with respect to an affected investor (a) by the timely filing with the Internal Revenue Service of an information return pursuant to section 6042 (i.e., Form 1099-DIV) that contains the required information and (b) by furnishing the affected investor with a copy of such information return. Thus, a nonpublicly offered regulated investment company or a nominee is not required to file more than one Form 1099-DIV with respect to an affected investor.

With respect to each affected investor, temporary §1.67-2T(o) requires a common trust fund to state on the return it is required to make pursuant to section 6032 the amount of the affected investor's proportionate share of the affected expenses for the taxable year as well as certain other information.

SPECIAL ANALYSES

No general notice of proposed rulemaking is required by 5 U.S.C. 553(b) for temporary regulations. Accordingly, the Regulatory Flexibility Act does not apply and no Regulatory Flexibility Analysis is required for this rule. The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. The reporting requirements added by this document have been submitted to the Office of Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduction Act of 1980. The reporting requirements have been approved by OMB.

* * * * *

Adoption of amendments to the regulations.

Accordingly, 26 CFR Part 1 is amended as follows:

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805.*** Section 1.67-2T and 1.67-3T also issued under 26 U.S.C. 67(c).

Par. 2. Section 1.62-1 is removed and a new §1.62-1T is added in its place to read as follows:

§1.62-1T Adjusted gross income (temporary).

(a) Basis for determining the amount of certain deductions. The term "adjusted gross income" means the gross income computed under section 61 minus such of the deductions allowed by chapter 1 of the Code as are specified in section 62(a). Adjusted gross income is used as the basis for determining the following:

(1) The limitation on the amount of miscellaneous itemized deductions (under section 67).

(2) The limitation on the amount of the deduction for casualty losses (under section 165(h)(2)),

(3) The limitation on the amount of the deduction for charitable contributions (under section 170(b)(1)),

(4) The limitation on the amount of the deduction for medical and dental expenses (under section 213),

(5) The limitation on the amount of the deduction for qualified retirement contributions for active participants in certain pension plans (under section 219(g), and

(6) The phase-out of the exemption from the disallowance of passive activity losses and credits (under section 469(i)(3)).

(b) *Double decution not permitted.* Section 62(a) merely specifies which of the deductions provided in chapter 1 of the Code shall be allowed in computing adjusted gross income. It does not create any new deductions. The fact that a particular item may be described in more than one of the paragraphs under section 62(a) does not permit the item to be deducted twice in computing adjusted gross income or taxable income.

(c) *Deductions allowable in computing adjusted gross income.* The deductions specified in section 62(a) for purposes of computing adjusted gross income are:

(1) Deductions allowable under chapter 1 of the Code (other than by part VII (section 211 and following), subchapter B of such chapter) that are attributable to a trade or business carried on by the taxpayer not consisting of services performed as an employee;

(2) Deductions allowable under part VI (section 161 and following), subchapter B, chapter 1 of the Code, that consist of expenses paid or incurred by the taxpayer in connection with the performance of services by him or her as an employee under an express reimbursement or other expense allowance arrangement (as defined in paragraph (f) of this section) with his or her employer;

(3) For taxable years beginning after December 31,1986, deductions allowable under section 162 that consist of expenses paid or incurred by a qualified performing artist (as defined in section 62(b)) in connection with the performance by him or her of services in the performing arts as an employee;

(4) Deductions allowable under part VI as losses from the sale or exchange of property;

(5) Deductions allowable under part VI, section 212, or section 611 that are attributable to property held for the production of rents or royalties;

(6) Deductions for depreciation or depletion allowable under sections 167 or 611 to a life tenant of property or to an income beneficiary of property held in trust or to an heir, legatee, or devisee of an estate;

(7) Deductions allowed by section 404 for contributions on behalf of a self-employed individual;

(8) Deductions allowed by section 219 for contributions to an individual retirement account described in section 408(a), or for an individual retirement annuity described in section 408(b);

(9) Deductions allowed by section 402(e)(3) with respect to a lump-sum distribution;

(10) For taxable years beginning after December 31, 1972, deductions allowed by section 165 for losses incurred in any transaction entered into for profit though not connected with a trade or business, to the extent that such losses include amounts forfeited to a bank, mutual savings bank, savings and loan association, building and loan association, cooperative bank or homestead association as a penalty for premature withdrawal of funds from a time savings account, certificate of deposit, or similar class of deposit;

(11) For taxable years beginning after December 31, 1976, deductions for alimony and separate maintenance payments allowed by section 215;

(12) Deductions allowed by section 194 for the amortization of reforestation expenditures; and

(13) Deductions allowed by section 165 for the repayment (made in a taxable year beginning after December 28, 1980) to a trust described in paragraph (9) or (17) of section 501(c) of supplemental unemployment compensation benefits received from such trust if such repayment is required because of the receipt of trade readjustment allowances under section 231 or 232 of the Trade Act of 1974 (19 U.S.C. 2291 and 2292).

(d) *Expenses directly related to a trade or business.* For the purpose of the deductions specified in section 62, the performance of personal services as an employee does not constitute the carrying on of a trade or business, except as otherwise expressly provided. The practice of a profession, not as an employee, is considered the conduct of a trade or business within the meaning of such section. To be deductible for the purposes of determining adjusted gross income, expenses must be those directly, and not those merely remotely, connected with the conduct of a trade or business. For example, taxes are deductible in arriving at adjusted gross income only if they constitute expenditures directly attributable to a trade or business or to property from which rents or royalties are derived. Thus, property taxes paid or incurred on real property used in a trade or business are deductible, but state taxes on net income are not deductible even though the taxpayer's income is derived from the conduct of a trade or business.

(e) *Reimbursed and unreimbursed employee expenses*—(1) *In general.* Expenses paid or incurred by an employee that are deductible from gross income under part VI in computing taxable income (determined without regard to section 67) and for which the employee is reimbursed by the employer, its agent, or third party (for whom the employee performs a benefit as an employee of the employer) under an express agreement for reimbursement or pursuant to an *express* expense allowance arrangement may be deducted from gross income in computing adjusted gross income. Except as provided in paragraph (e)(2) and (e)(4) of this section, for taxable years beginning after December 31, 1986, if the amount of a reimbursement (as defined in paragraph (f) of this section) made by an employer, its agent, or third party to an employee is less than the total amount of the business expenses paid or incurred by the employee, the determination of to which of the employee's business expenses the reimbursement applies and the amount of each expense that is covered by the reimbursement is made on the basis of all of the facts and circumstances of the particular case.

(2) *Facts and circumstances unclear on business expenses for meals and entertainment. If*—

(i) The facts and circumstances do not make clear—

(A) That a reimbursement does not apply to business expenses for meals or entertainment, or

(B) The amount of business expenses for meals or entertainment that is covered by the reimbursement, and

(ii) The employee pays or incurs business expenses for meals or entertainment,

the amount of the reimbursement that applies to such expenses (or portion thereof with respect to which the facts and circumstances are unclear) shall be determined by multiplying the amount of the employee's business expenses for meals and entertainment (or portion thereof with respect to which the facts and circumstances are unclear) by a fraction, the numerator of which is the total amount of the reimbursement (or portion thereof with respect to which the facts and circumstances are unclear) and the denominator of which is the aggregate amount of all the business expenses of the employee (or portion thereof with respect to which the facts and circumstances are unclear).

(3) *Deductibility of unreimbursed expenses.* The amount of expenses that is determined not to be reimbursed pursuant to paragraph (e)(1) or (2) of this section is deductible from adjusted gross income in determining the employee's taxable income subject to the limitations applicable to such expenses (*e.g.*, the 2-percent floor of section 67 and the 80-percent limitation on meal and entertainment expenses provided for in section 274(n)).

(4) *Unreimbursed expenses of State legislators.* For taxable years beginning after December 31, 1986, any portion of the amount allowed as a deduction to State legislators pursuant to section 162(h)(1)(B) that is not reimbursed by the State or a third party shall be allocated between lodging and meals in the same ratio as the amounts allowable for lodging and meals under the Federal per diem applicable to the legislator's State capital at the end of the legislator's taxable year (see Appendix 1-A of the Federal Travel Regulations (FTR), which as of March 28, 1988 are contained in GSA Bulletin FPMR A-40, Supplement 20). For purposes of this paragraph (e)(4), the amount allowable for meals under the Federal per diem shall be the amount of the Federal per diem allowable for meals and incidental expenses reduced by $2 per legislative day (or other amount allocated to incidental expenses in 1-7.5(a)(2) of the FTR). The unreimbursed portion of each type of expense is deductible from adjusted gross income in determining the State legislator's taxable income subject to the limitations applicable to such expenses. For example, the unreimbursed portion allocable to meals shall be reduced by 20 percent pursuant to section 274(n) before being subjected to the 2-percent floor of section 67 for purposes of computing the taxable income of a State legislator. See §1.67-1T(a)(2).

(5) *Expenses paid directly by an employer, its agent, or third party.* In the case of an employer, its agent, or a third party who provides property or services to an employee or who pays an employee's expenses directly instead of reimbursing the employee, see section 132 and the regulations thereunder for the income tax treatment of such expenses.

(6) *Examples.* The provisions of this paragraph (e) may be illustrated by the following examples:

Example (1). During 1987, A, an employee, while on business trips away from home pays $300 for travel fares, $200 for lodging and $100 for meals. In addition, A pays $50 for business meals in the area of his place of employment ("local meals"), $250 for continuing education courses, and $100 for business-related entertainment (other than meals). The total amount of the reimbursements received by A for his employee expenses from his employer is $750, and it is assumed that A's expenses meet the deductibility requirements of sections 162 and 274. A includes the amount of the reimbursement in his gross income. A's employer designates the reimbursement to cover in full A's expenses for travel fares, lodging, and meals while away from home, local meals, and entertainment, and no facts or circumstances indicate a contrary intention of the employer. Because the facts and circumstances make clear the amount of A's business expenses for meals and entertainment that is covered by the reimbursement, the reimbursement will be allocated to these expenses. In determining his adjusted gross income under section 62, A may deduct the full amount of the reimbursement for travel fares, lodging, and meals while away from home, local meals, and entertainment. In determining his taxable income under section 63, A may deduct his expenses for continuing education courses to the extent allowable by sections 67 and 162.

Example (2). Assume the facts are the same as in example (1) except that the facts and circumstances make clear that the reimbursement covers all types of deductible expenses but they do not make clear the amount of each type of expense that is covered by the reimbursement. The amount of the reimbursement that is allocated to A's business expenses for meals and entertainment is $187.50. This amount is determined by multiplying the total amount of A's business expenses for meals and entertainment ($250) by the ratio of A's total reimbursement to A's total business expenses ($750/$1000). The remaining amount of the reimbursement, $562.50 ($750 − $187.50), is allocated to A's business expenses other than meal and entertainment expenses. Therefore, in determining his adjusted gross income under section 62, A may deduct $750 for reimbursed business expenses (including meals and entertainment). In determining his taxable income under section 63, A may deduct (subject to the limitations and conditions of sections 67, 162, and 274) the unreimbursed portion of his expenses for meals and entertainment ($62.50 ($250 − $187.50)), and other employee business expenses ($187.50 ($750 − $562.50)).

Example (3). Assume the facts are the same as in example (1) except that the amount of the reimbursement is $500. Assume further that the facts and circumstances make clear that the reimbursement covers $100 of expenses for meals and that the remaining $400 of the reimbursement covers all types of deductible expenses (including any expenses for meals in excess of the $100 already designated) other than expenses for entertainment. The amount of the reimbursement that is allocated to A's business expenses for meals and entertainment is $125. This amount is equal to the sum of the amount of the reimbursement that clearly applies to meals ($100) and the amount of the reimbursement with respect to which the facts are unclear that is allocated to meals ($25). The latter amount is determined by multiplying the total amount of A's business expenses for meals and entertainment with respect to which the facts are unclear ($50) by the ratio of A's total reimbursement with respect to which the facts are unclear to A's total business expenses with respect to which the facts are unclear ($400/$800). The remaining amount of the reimbursement, $375 ($500 − 125) is allocated to A's business expenses other than meals and entertainment. Therefore, in determining his adjusted gross income under section 62, A may deduct $500 for reimbursed business expenses (including meals). In determining his taxable income under section 63, A may deduct (subject to the limitations and conditions of sections 67, 162, and 274) the unreimbursed portion of his expenses for meals ($25 ($150 − $125)), entertainment ($100), and other employee business expenses ($375 ($750 − $375)).

Example (4). During 1987 B, a research scientist, is employed by Corporation X. B gives a speech before members of Association Y, a professional organization of scientists, describing her most recent research findings. Pursuant to a reimbursement arrangement, Y reimburses B for the full amount of her travel fares to the site of the speech and for the full amount of her expenses for lodging and meals while there. B includes the amount of the reimbursement in her gross income. B may deduct the full amount of her travel expenses pursuant to section 62(a)(2)(A) in computing her adjusted gross income.

(f) *Reimbursement or other expense allowance arrangement.* For purposes of this section, the phrase "reimbursement or other expense allowance arrangement" means advances, allowances (including per diem allowances and mileage allowances), or reimbursements received by a taxpayer for business expenses that are allowable as deductions by part VI and paid or incurred by the taxpayer in connection with the performance of services by him or her as an employee under a reimbursement or other expense allowance arrangement with the employer (whether the reimbursement is actually received from the employer, its agent, or a third party, for whom the employee performs a benefit as an employee of the employer), as well as amounts charged directly or indirectly to the employer through credit card systems or otherwise. In addition, the reimbursement or other expense allowance arrangement must be identified either (1) by making a separate payment or (2) by specifically indicating the separate amount if both wages and the reimbursement or expense allowance are combined in a single payment. It shall be presumed that any amounts treated as compensation to an employee by an employer on the employer's return of tax under chapter 1 of the Code and as wages to such employee for purposes of chapter 24 of the Code (relating to withholding of income tax at source on wages) do not constitute reimbursements or other expense allowances for purposes of section 62 and this section. This presumption may be rebutted by clear and convincing evidence to the contrary that includes evidence of an obligation by the employee to make an adequate accounting (as defined in §1.274-5(e)(4)) to the employer for the employee's business expenses.

(g) *Moving expenses.* For taxable years beginning after December 31, 1986, a taxpayer described in section 217(a) shall not take into account the deduction described in section 217 relating to moving expenses in computing adjusted gross income under section 62 even if the taxpayer is reimbursed for his or her moving expenses. Such a taxpayer shall include the amount of any reimbursement for moving expenses in income pursuant to section 82. The deduction described in section 217 shall be taken into account in computing the taxable income of the taxpayer under section 63. Pursuant to section 67(b)(6), the 2-percent floor described in section 67(a) does not apply to moving expenses.

(h) *Cross-reference.* See 26 CFR 1.62-1 (Rev. as of April 1, 1986) with respect to pre-1987 deductions for travel, meal, lodging, transportation, and other trade or business expenses of an employee, reimbursed expenses of an employee, expenses of an outside salesperson, long-term capital gains, contributions described in section 405(c) to a bond purchase plan on behalf of a self-employed individual, moving expenses, amounts not received as benefits pursuant to section 1379(b)(3), and retirement bonds described in section 409 (allowed by section 219).

Par. 3. Immediately after §1.63-2, new §§1.67-1T and 1.67-2T are added, and §1.67-4T is reserved. The added provisions read as follows:

§1.67-1T 2-percent floor on miscellaneous itemized deductions (temporary).

(a) *Type of expenses subject to the floor*—(1) *In general.* With respect to individuals, section 67 disallows deductions for miscellaneous itemized deductions (as defined in paragraph (b) of this section) in computing taxable income (*i.e.*, so-called "below-the-line" deductions) to the extent that such otherwise allowable deductions do not exceed 2 percent of the individual's adjusted gross income (as defined in section 62 and the regulations thereunder). Examples of expenses that, if otherwise deductible, are subject to the 2-percent floor include but are not limited to—

(i) Unreimbursed employee expenses, such as expenses for transportation, travel fares and lodging while away from home, business meals and entertainment, continuing education courses, subscriptions to professional journals, union or professional dues, professional uniforms, job hunting, and the business use of the employee's home,

(ii) Expenses for the production or collection of income for which a deduction is otherwise allowable under section 212(1) and (2), such as investment advisory fees, subscriptions to investment advisory publications, certain attorneys' fees, and the cost of safe deposit boxes,

(iii) Expenses for the determination of any tax for which a deduction is otherwise allowable under section 212(3), such as tax counsel fees and appraisal fees, and

(iv) Expenses for an activity for which a deduction is otherwise allowable under section 183.

See section 62 with respect to deductions that are allowable in computing adjusted gross income (*i.e.*, so-called "above-the-line" deductions).

(2) *Other limitations.* Except as otherwise provided in paragraph (d) of this section, to the extent that any limitation or restriction is placed on the amount of a miscellaneous itemized deduction, that limitation shall apply prior to the application of the 2-percent floor.

For example, in the case of an expense for food or beverages, only 80 percent of which is allowable as a deduction because of the limitations provided in section 274(n), the otherwise deductible 80 percent of the expense is treated as a miscellaneous itemized deduction and is subject to the 2-percent limitation on section 67.

(b) *Definition of miscellaneous itemized deductions.* For purposes of this section, the term "miscellaneous itemized deductions" means the deductions allowable from adjusted gross income in determining taxable income, as defined in section 63, other than—

(1) The standard deduction as defined in section 63(c),

(2) Any deduction allowable for impairment-related work expenses as defined in section 67(d),

(3) The deduction under section 72(b)(3) (relating to deductions if annuity payments cease before the investment is recovered),

(4) The deductions allowable under section 151 for personal exemptions,

(5) The deduction under section 163 (relating to interest),

(6) The deduction under section 164 (relating to taxes),

(7) The deduction under section 165(a) for losses described in subsection (c)(3) or (d) of section 165,

(8) The deduction under section 170 (relating to charitable contributions and gifts),

(9) The deduction under section 171 (relating to deductions for amortizable bond premiums),

(10) The deduction under section 213 (relating to medical and dental expenses),

(11) The deduction under section 216 (relating to deductions in connection with cooperative housing corporations),

(12) The deduction under section 217 (relating to moving expenses),

(13) The deduction under section 691(c) (relating to the deduction for estate taxes in the case of income in respect of the decedent),

(14) The deduction under 1341 (relating to the computation of tax if a taxpayer restores a substantial amount held under claim of right), and

(15) Any deduction allowance in connection with personal property used in a short sale.

(c) *Allocation of expenses.* If a taxpayer incurs expenses that relate to both a trade or business activity (within the meaning of section 162) and a production of income or tax preparation activity (within the meaning of section 212), the taxpayer shall allocate such expenses between the activities on a reasonable basis.

(d) *Members of Congress*—(1) *In general.* With respect to the deduction for living expenses of Members of Congress referred to in section 162(a), the 2-percent floor described in section 67 and paragraph (a) of this section shall be applied to the deduction before the application of the $3,000 limitation on deductions for living expenses referred to in section 162(a). (For purposes of this paragraph (d), the term "Member(s) of Congress" includes any Delegate or Resident Commissioner.) The amount of miscellaneous itemized deductions of a Member of Congress that is disallowed pursuant to section 67 and paragraph (a) of this section shall be allocated between deductions for living expenses (within the meaning of section 162(a)) and other miscellaneous itemized deductions. The amount of deductions for living expenses of a Member of Congress that is disallowed pursuant to section 67 and paragraph (a) of this section is determined by multiplying the aggregate amount of such living expenses (determined without regard to the $3,000 limitation of section 162(a) but with regard to any other limitations) by a fraction, the numerator of which is the aggregate amount disallowed pursuant to section 67 and paragraph (a) of this section with respect to miscellaneous itemized deductions of the Member of Congress and the denominator of which is the amount of miscellaneous itemized deductions (including deductions for living expenses) of the Member of Congress (determined without regard to the $3,000 limitation of section 162(a) but with regard to any other limitations). The amount of deductions for miscellaneous itemized deductions (other than deductions for living expenses) of a Member of Congress that are disallowed pursuant to section 67 and paragraph (a) of this section is determined by multiplying the amount of miscellaneous itemized deductions (other than deductions for living expenses) of the Member of Congress (determined with regard to any limitations) by the fraction described in the preceding sentence.

(2) *Example.* The provision of this paragraph (d) may be illustrated by the following example:

Example. For 1987 A, a Member of Congress, has adjusted gross income of $100,000, and miscellaneous itemized deductions of $10,750 of which $3,750 is for meals, $3,000 is for other living expenses, and $4,000 is for other miscellaneous itemized deductions (none of which is subject to any percentage limitations other than the 2-percent floor of section 67). The amount of A's business meal expenses that are disallowed under section 274(n) is $750 ($3,750 × 20%). The amount of A's miscellaneous itemized deductions that are disallowed under section 67 is $2,000 ($100,000 × 2%). The portion of the amount disallowed under section 67 that is allocated to A's living expenses is $1,200. This portion is equal to the amount of A's deductions for living expenses allowable after the application of section 274(n) and before the application of section 67 ($6,000) multiplied by the ratio of A's total miscellaneous itemized deductions disallowed under section 67 to A's total miscellaneous itemized deductions, determined without regard to the $3,000 limitation of section 162(a) ($2,000/$10,000). Thus, after application of section 274(n) and section 67, A's deduction for living expenses is $4,800 ($6,750 − $750 − $1,200). However, pursuant to section 162(a), A may deduct only $3,000 of such expenses. The amount of A's other miscellaneous itemized deductions that are disallowed under section 67 is $800 ($4,000 × $2,000/$10,000). Thus, $3,200 ($4,000 − $800) of A's miscellaneous itemized deductions (other than deductions for living expenses) are allowable after application of section 67. A's total allowable miscellaneous itemized deductions are $6,200 ($3,000 + $3,200).

(e) *State legislators.* See §1.62–1T(e)(4) with respect to rules regarding state legislator's expenses.

§1.67–2T Treatment of Pass-Through Entities (temporary)

(a) *Application of section 67.* This section provides rules for the application of section 67 to partners, shareholders, beneficiaries, participants, and others with respect to their interests in pass-through entities (as defined in paragraph (g) of this section). In general, an affected investor (as defined in paragraph (h) of this section) in a pass-through entity shall separately take into account as an item of income and as an item of expense an amount equal to his or her allocable share of the affected expenses (as defined in paragraph (i) of this section) of the pass-through entity for purposes of determining his or her taxable income. Except as provided in paragraph (e)(1)(ii)(B) of this section, the expenses so taken into account shall be treated as paid or incurred by the affected investor in the same manner as paid or incurred by the pass-through entity. For rules regarding the application of section 67 to affected investors in—

(1) Partnerships, S corporations, and grantor trusts, see paragraph (b) of this section,

(2) Real estate mortgage investment conduits, see paragraph (c) of this section,

(3) Common trust funds, see paragraph (d) of this section,

(4) Nonpublicly offered regulated investment companies, see paragraph (e) of this section, and

(5) Publicly offered regulated investment companies, see paragraph (p) of this section.

(b) *Partnerships, S corporations, and grantor trusts*—(1) *In general.* Pursuant to sections 702(a) and 1366(a) of the Code and the regulations thereunder, each partner of a partnership or shareholder of an S corporation shall taken into account separately his or her distributive or pro rata share of any items of deduction of such partnership or corporation that are defined as miscellaneous itemized deductions pursuant to section 67(b). The 2-percent limitation described in section 67 does not apply to the partnership or corporation with respect to such deductions, but such deductions shall be included in the deductions of the partner or shareholder to which that limitation applies. Similarly, the limitation applies to the grantor or other person treated as the owner of a grantor trust with respect to items that are paid or incurred by a grantor trust and are treated as miscellaneous itemized deductions of the grantor or other person pursuant to subpart E, part 1, subchapter J, chapter 1 of the Code, but not to the trust itself. The 2-percent limitation applies to amounts otherwise deductible in taxable years of partners, shareholders, or grantors beginning after December 31, 1986, regardless of the taxable years of the partnership, corporation, or trust.

(2) *Example.* The provisions of this paragraph (b) may be illustrated by the following example:

Example. P, a partnership, incurs $1,000 in expenses to which section 212 applies during its taxable year. A, an individual, is a partner in P. A's distributive share of the expenses to which section 212 applies is $20, determined without regard to the 2-percent limitation of section 67. Pursuant to section 702(a), A must take $20 of expenses to which section 212 applies into account in determining his income tax. Pursuant to section 67, in determining his taxable income A may deduct his miscellaneous itemized deductions (including his $20 distributive share of deductions from P) to the extent the total amount exceeds 2 percent of his adjusted gross income.

(c) *Real estate mortgage investment conduit.* See §1.67-3T for rules regarding the application of section 67 to holders of interests in REMICs.

(d) *Common trust funds*—(1) *In general.* For purposes of determining the taxable income of an affected investor that is a participant in a common trust fund—

(i) The ordinary taxable income and ordinary net loss of the common trust shall be computed under section 584(d)(2) without taking into account any affected expenses, and

(ii) Each affected investor shall be treated as having paid or incurred an expense described in section 212 in an amount equal to the affected investor's proportionate share of the affected expenses.

The 2-percent limitation described in section 67 applies to amounts otherwise deductible in taxable years of participants beginning after December 31, 1986, regardless of the taxable year of the common trust fund.

(2) *Example.* The provision of this paragraph (d) may be illustrated by the following example:

Example. During 1987, the gross income and deductions of common trust fund C, a calendar year taxpayer, consist of the following items: (i) $50,000 of short-term capital gains; (ii) $150,000 of long-term capital gains; (iii) $1,000,000 of divided income; (iv) $10,000 of deductions that are affected expenses; and (v) $60,000 of deductions that are affected expenses. The proportionate share of Trust T in the income and losses of C is one percent. In computing its taxable income for 1987, T, a calendar year taxpayer, shall take into account the following items: (A) $500 of short-term capital gains (one percent of $50,000, C's short-term capital gains); (B) $1,500 of long-term capital gains (one percent of $150,000, C's long-term capital gains); (C) $9,900 of ordinary taxable income (one percent of $990,000, the excess of $100,000, C's gross income after excluding capital gains and losses, over $10,000, C's deductions that are not affected expenses); (D) $600 of expenses described in section 212 (one percent of $60,000, C's affected expenses).

(e) *Nonpublicly offered regulated investment companies*—(1) *In general.* For purposes of determining the taxable income of an affected investor that is a shareholder of a nonpublicly offered regulated investment company (as defined in paragraph (g)(3) of this section) during a calendar year—

(i) The current earnings and profits of the nonpublicly offered regulated investment company shall be computed without taking into account any affected RIC expenses that are allocated among affected investors, and

(ii) The affected investor shall be treated—

(A) As having received or accrued a dividend in an amount equal to the affected investor's allocable share of the affected RIC expenses of the nonpublicly offered regulated investment company for the calendar year, and

(B) As having paid or incurred an expense described in section 212 (or section 162 in the case of an affected investor that is a nonpublicly offered regulated investment company) in an amount equal to the affected investor's allocable share of the affected RIC expenses of the nonpublicly offered regulated investment company for the calendar year in the affected investor's taxable year with which (or within which) the calendar year with respect to which the expenses are allocated ends. An affected investor's allocable share of the affected RIC expense is the amount allocated to that affected investor pursuant to paragraph (k) of this section.

(2) *Shareholders that are not affected investors.* A shareholder of a

nonpublicly offered regulated investment company that is not an affected investor shall not take into account in computing its taxable income any amount of income or expense with respect to its allocable share of affected RIC expenses.

(3) *Example.* The provisions of this paragraph (e) may be illustrated by the following example:

Example. During calendar year 1987, nonpublicly offered regulated investment company M distributes to individual shareholder A, a calendar year taxpayer, capital gain dividends of $1,000 and other dividends of $5,000. A's allocable share of the affected RIC expenses of M is $200. In computing A's taxable income for 1987, A shall take into account the following items: (i) $1,000 of long-term capital gains (the capital gain dividends received by A); (ii) $5,200 of dividend income (the sum of the other dividends received by A and A's allocable share of the affected RIC expenses of M); and (iii) $200 of expenses described in section 212 (A's allocable share of the affected RIC expenses of M). A is allowed a deduction for miscellaneous itemized deductions (including A's $200 allocable share of the affected RIC expenses of M, which is treated as an expense described in section 212) for 1987 only to the extent the aggregate of such deductions exceeds 2 percent of A's adjusted gross income for 1987.

(f) *Cross-reference.* See §1.67-1T with respect to limitations on deductions for expenses described in section 212 (including amounts treated as such expenses under this section).

(g) *Pass-through-entity*—(1) *In general.* Except as provided in paragraph (g)(2) of this section, for purposes of section 67(c) and this section, a pass-through entity is—

(i) A trust (or any portion thereof) to which subpart E, part 1, subchapter J, chapter 1 of the Code applies,

(ii) A partnership,

(iii) An S corporation,

(iv) A common trust fund described in section 584,

(v) A nonpublicly offered regulated investment company,

(vi) A real estate mortgage investment conduit, and

(vii) Any other person—

(A) Which is not subject to the income tax imposed by subtitle A, chapter 1, or which is allowed a deduction in computing such tax for distributions to owners or beneficiaries, and

(B) The character of the income of which may affect the character of the income recognized with respect to that person by its owners or beneficiaries. Entities that do not meet the requirements of paragraph (g)(1)(vii) (A) and (B), such as qualified pension plans, individual retirement accounts, and insurance companies holding assets in separate asset accounts to fund variable contracts defined in section 817(d), are not described in this paragraph (g)(1).

(2) *Exception.* For purposes of section 67(c) and this section, a pass-through entity does not include:

(i) An estate;

(ii) A trust (or any portion thereof) not described in paragraph (g)(1)(i) of this section,

(iii) A cooperative described in section 1381(a)(2), determined without regard to subparagraphs (A) and (C) thereof, or

(iv) A real estate investment trust.

(3) *Nonpublicly offered regulated investment company*—(i) *In general.* For purposes of this section, the term "nonpublicly offered regulated investment company" means a regulated investment company to which part I of subchapter M of the Code applies that is not a publicly offered regulated investment company.

(ii) *Publicly offered regulated investment company.* For purposes of this section, the term "publicly offered regulated investment company" means a regulated investment company to which part I of subchapter M of the Code applies the share of which are—

(A) Continuously offered pursuant to a public offering (within a meaning of section 4 of the Securities Act of 1933, as amended (15 U.S.C. 77a to 77aa)),

(B) Regularly traded on an established securities market, or

(C) Held by or for no fewer than 500 persons at all times during the taxable year.

(h) *Affected investor*—(1) *In general.* For purposes of this section, the term "affected investor" means a partner, shareholder, beneficiary, participant, or other interest holder in a pass-through entity's taxable year that is—

(i) An individual (other than a nonresident alien whose income with respect to his or her interest in the pass-through entity is not effectively connected with the conduct of a trade or business within the United Sates),

(ii) A person, including a trust or estate, that computes its taxable income in the same manner as in the case of an individual; or

(iii) A pass-through entity if one or more of its partners, shareholders, beneficiaries, participants, or other interest holders is (A) a pass-through entity or (B) a person described in paragraph (h)(1)(i) or (ii) of this section.

(2) *Examples.* The provisions of this paragraph (h) may be illustrated by the following examples:

Example (1). Corporation X holds shares of nonpublicly offered regulated investment company R in its capacity as a nominee or custodian for individual A, the beneficial owner of the shares. Because the owner of the shares for Federal income tax purposes is an individual, the shares are owned by an affected investor.

Example (2). Individual retirement account I owns shares of a nonpublicly offered regulated investment company. Because an individual retirement account is not a person described in paragraph (h)(1) of this section, the shares are not owned by an affected investor.

(i) *Affected expenses*—(1) *In general.* In general, for purposes of this section, the term "affected expenses" means expenses that, if paid or incurred by an individual, would be deductible, if at all, as miscellaneous itemized deductions as defined in section 67(b).

(2) *Special rule for nonpublicly offered regulated investment companies.* In the case of a nonpublicly offered regulated investment company, the term "affected expenses" means only affected RIC expenses.

(j) *Affected RIC expenses*—(i) *In general.* In general, for purposes of this section, the term "affected RIC expenses" means the excess of—

(ii) The aggregate amount of the expenses (other than expenses described in sections 62(a)(3) and 67(b) and § 1.67-1T(b)) paid or incurred in the calendar year that are allowable as a deduction in determining the investment company taxable income (without regard to section 852(b)(2)(D)) of the nonpublicly offered regulated investment company for a taxable year that begins or ends with or within the calendar year, over

(ii) The amount of expenses taken into account under paragraph (j)(1)(i) of this section that are allocable to the following items (whether paid separately or included as part of a fee paid to an investment advisor or other person for a variety of services):

(A) Registration fees;

(B) Directors' or trustees' fees;

(C) Periodic meetings of directors, trustees, or shareholders;

(D) Transfer agent fees;

(E) Legal and accounting fees (other than fees for income tax return preparation or income tax advice); and

(F) shareholder communications required by law (*e.g.*, the preparation and mailing of prospectuses and proxy statements).

Expenses described in paragraph (j)(1)(ii)(A) through (F) of this section do not include, for example, expenses allocable to investment advice, marketing activities, shareholder communications and other services not specifically described in paragraph (j)(1)(ii)(A) through (F) of this section, and custodian fees.

(2) *Safe harbor.* If a nonpublicly offered regulated investment company makes an election under this paragraph (j)(2), the affected RIC expenses for a calendar year shall be treated as equal to 40 percent of the amount determined under paragraph (j)(1)(i) of this section for that calendar year. The nonpublicly offered regulated investment company shall make the election by attaching to its income tax return for the taxable year that includes the last day of the first calendar year for which the nonpublicly offered regulated investment company makes the election a statement that it is making an election under paragraph (j)(2) of this section. An election made pursuant to this paragraph (j)(2) shall remain in effect for all subsequent calendar years unless revoked with the consent of the Commissioner.

(3) *Reduction for unused RIC expenses.* The amount determined under paragraph (j)(1)(i) of this section shall be reduced by the nonpublicly offered regulated investment company's net operating loss, if any, for the taxable year ending with or within the calendar year. In computing the nonpublicly offered regulated investment company's net operating loss for purposes of this section, the deduction for dividends paid shall not be allowed and any net capital gain for the taxable year shall be excluded.

(4) *Exception.* The affected RIC expenses of a nonpublicly offered regulated investment company will be treated as zero if the amount of its gross income for the calendar year (determined without regard to capital gain net income) is not greater than 1 percent of the sum of (i) such gross income and (ii) the amount of its interest income for the calendar year that is not includible in gross income pursuant to section 103.

(k) *Allocation of expenses among nonpublicly offered regulated investment company shareholders*—(1) *General rule.* A nonpublicly offered regulated investment company shall allocate to each of its affected investors that is a shareholder at any time during the calendar year, the affected investor's allocable share of the affected RIC expenses of the nonpublicly offered regulated investment company for that calendar year. (See paragraph (m) of this section for rules regarding estimates with respect to the amount of an affected investor's share of affected RIC expenses upon which certain persons can rely for certain purposes.) A nonpublicly offered regulated investment company may use any reasonable method to make the allocation. A method of allocation shall not be reasonable if—

(i) The method can be expected to have the effect, if applied to all affected RIC expenses and all shareholders (whether or not affected investors), of allocating to the shareholders an amount of affected RIC expenses that is less than the affected RIC expenses of the nonpublicly offered regulated investment company for the calendar year.

(ii) The method can be expected to have the effect of allocating a disproportionately high share of the affected RIC expenses of the nonpublicly offered regulated investment company to (A) shareholders that are not affected investors or (B) affected investors, the amount of whose miscellaneous itemized deductions (including their allocable share of affected RIC expenses) exceeds the 2-percent floor described in section 67, or

(iii) A principal purpose of the method of allocation is to avoid allocating affected RIC expenses to persons described in paragraph (h)(1)(i) or (ii) of this section whose miscellaneous itemized deductions (inclusive of their allocable share of affected RIC expenses) may not exceed the 2-percent floor described in section 67.

(2) *Reasonable allocation method described*—(i) *In general.* The allocation method described in this paragraph (k)(2) shall be treated as a reasonable allocation method. Under the method described in this paragraph, an affected investor's allocable share of the affected RIC expenses of a nonpublicly offered regulated investment company is the amount that bears the same ratio to the amount of affected RIC expenses of the nonpublicly offered regulated investment company for the calendar year as—

(a) The amount of dividends paid to the affected investor during the calendar year, bears to

(B) The sum of—

(*1*) The aggregate amount of dividends paid by the nonpublicly offered regulated investment company during the calendar year to all shareholders, and

(*2*) Any amount on which tax is imposed under section 852(b)(1) for any taxable year of the nonpublicly offered regulated investment company ending within or with the calendar year.

(ii) *Exception.* Paragraph (k)(2)(i) of this section does not apply if the amount of the deduction for dividends paid during the calendar year is zero.

(iii) *Dividends paid.* For purposes of this paragraph (k)(2)—

(A) Dividends that are treated as paid during a calendar year pursuant to section 852(b)(7) are treated as paid during that calendar year and not during the succeeding calendar year.

(B) The term "dividends paid" does not include capital gain dividends (as defined in section 852(b)(3)(C)), exempt-interest dividends (as defined in section 852(b)(5)(A)), or any amount to which section 302(a) applies.

(C) The dividends paid during a calendar year is determined without regard to section 855(a).

(3) *Reasonable allocation made by District Director.* If a nonpublicly offered regulated investment company does not make a reasonable allocation of affected RIC expenses to its affected investor as required by paragraph (k)(1) of this section, a reasonable allocation shall be made by the District Director of the internal revenue district in which the principal place of business or principal office or agency of the nonpublicly offered regulated investment company is located.

(4) *Examples.* The provisions of this paragraph (k) may be illustrated by the following examples:

Example (1). Nonpublicly offered regulated investment company M, in calculating its investment company taxable income, claims a dividends paid deduction for a portion of redemption distributions (to which section 302(a) applies) to shareholders, as well as for nonredemption distributions. M allocates affected expenses among shareholders who have received nonredemption distributions by multiplying the amount of nonredemption distributions distributed to each shareholder by a fraction, the numerator of which is the affected RIC expenses of M and the denominator of which is M's investment company taxable income, determined on a calendar year basis and without regard to deductions described in section 852(b)(2)(D). No affected RIC expenses are allocated with respect to the redemption distributions. This allocation method can be expected to have the effect of allocating among the shareholders an amount of expenses that is less than the total amount of affected RIC expenses of M. Accordingly, the allocation method is not reasonable.

Example (2). Nonpublicly offered regulated investment company N has two classes of stock, a "capital" class and an "income" class. Owners of the capital class receive the benefit of all capital appreciation on the stocks owned by N, and bear the burden of certain capital expenditures of N; owners of the income class receive the benefit of all other income of N, and bear the burden of all expenses of N that are deductible under section 162. M allocates all affected RIC expenses among shareholders of the income class shares under a method that would be reasonable if the income class were the only class of N stock. Corporations and other shareholders that are not affected investors own a higher proportion of income class shares than of capital class shares. The affected RIC expenses of N are properly allocated among the shareholders who bear the burden of those expenses. Accordingly, the allocation method does not have the effect of allocating a disproportionately high share of the affected RIC expenses of N to shareholders that are not affected investors merely because a disproportionate share of income class shares are owned by shareholders that are not affected investors. The allocation method is reasonable.

Example (3). Nonpublicly offered regulated investment company O has two classes of stock, Class A and Class B. Shares of Class A, which may be purchased without payment of a sales or brokerage commission, are charged with the expenses of a Rule 12b–1 distribution plan of O. Shares of Class B, which may be purchased only upon payment of a sales or brokerage commission, are not charged with the expenses of the Rule 12b–1 distribution plan of O. O allocates all affected RIC expenses among shareholders of Class A and Class B shares under a method that would be reasonable if Class A or Class B shares, respectively, were the only class of O stock. The affected RIC expenses attributable to the Rule 12b–1 plan are allocated to the shareholders of Class A shares. Shareholders that are not affected investors own a higher proportion of Class A shares than of Class B shares. The affected RIC expenses of O are properly allocated among the shareholders who bear the burden of those expenses. Accordingly, the allocation method does not have the effect of allocating a disproportionately high share of the affected RIC expenses of O to shareholders that are not affected investors merely because a disproportionately high share of Class A shares are owned by persons that are not affected investors. The allocation method is reasonable.

Example (4). Assume the facts are the same as in example (3) except that a portion of the affected RIC expenses attributable to the Rule 12b–1 plan are allocated to the shareholders of Class B shares, and shareholders that are not affected investors own a higher proportion of Class B shares than of Class A shares. Thus, the affected RIC expenses are not allocated among the class of shareholders that bear the burden of the expenses. Accordingly, the allocation method has the effect of allocating a disproportionate share of the affected RIC expenses of O to the shareholders of Class B shares. Because shareholders that are not affected investors own a higher proportion of Class B shares than Class A shares, the method can be expected to allocate a disproportionately high share of the affected RIC expenses of O to shareholders that are not affected investors. Accordingly, the allocation method is not reasonable.

(l) *Affected RIC expenses not subject to backup withholding.* The amount of dividend income that an affected investor in a nonpublicly offered regulated investment company is treated as having received or accrued under paragraph (e)(1)(ii) of this section is not subject to backup withholding under section 3406.

(m) *Reliance by nominees and pass-through investors on notices*—(1) *General Rule.* Persons described in paragraph (m)(3) of this section may, for the purposes described in that paragraph (m)(3), treat an affected investor's allocable share of the affected RIC expenses of a nonpublicly offered regulated investment company as being equal to an amount determined by the nonpublicly offered regulated investment company on the basis of a reasonable estimate (*e.g.*, of allocable expenses as a percentage of dividend distributions or allocable expenses per share) that is (i) reported in writing by the nonpublicly offered regulated investment company to the person or (ii) reported in a newspaper or financial publication having a nationwide circulation (*e.g.*, the *Wall Street Journal* or *Standard and Poor's Weekly Dividend Record*).

(2) *Estimates must be reasonable.* In general, for purposes of paragraph (m)(1) of this section, estimates of affected RIC expenses of a nonpublicly offered regulated investment company will be treated as reasonable only if the nonpublicly offered regulated investment company makes a reasonable effort to offset material understatements (or overstatements) of affected RIC expenses for a period of increasing (or decreasing) estimates of affected RIC expenses for a subsequent period. Understatements or overstatements of affected RIC expenses that are not material may be corrected by making offsetting adjustments in future periods, provided that understatements and overstatements are treated consistently.

(3) *Application.* Paragraph (m)(1) of this section shall apply to the following persons for the following purposes:

(i) A nominee who, pursuant to section 6042(a)(1)(B) and paragraph (n)(2) of this section, is required to report dividends paid by a nonpublicly offered regulated investment company to the Internal Revenue Service and to the person to whom the payment is made, for purposes of reporting to the Internal Revenue Service and the person to whom the payment is made the amount of affected RIC expenses allocated to such person.

(ii) An affected investor to whom a nominee (to which paragraph (m)(3)(i) of this section applies) reports, for purposes of calculating the affected investor's taxable income and the amount of its affected expenses.

(iii) A shareholder that is a pass-through entity, for purposes of calculating its taxable income and the amount of its affected expenses.

(n) *Return of information and reporting to affected investors by a nonpublicly offered regulated investment company*—(1) *In general*—(i) *Return of information.* A nonpublicly offered regulated investment company shall make an information return (*e.g.*, Form 1099-DIV, Dividends and Distributions, for 1987) with respect to each affected investor to which an allocation of affected RIC expenses is required to be made pursuant to paragraph (k) of this section and for which the nonpublicly offered regulated investment company is required to make an information return to the Internal Revenue Service pursuant to section 6042 (or would be required to make such information return but for the $10 threshold described in section 6042(a)(1)(A) and (B)). The nonpublicly offered regulated investment company shall make the information return for each calendar year and shall state separately on such return—

(A) The amount of affected RIC expenses required to be allocated to the affected investor for the calendar year pursuant to paragraph (k) of this section,

(B) The sum of—

(*1*) The aggregate amount of the dividends paid to the affected investor during the calendar year, and

(*2*) The amount of the affected RIC expenses required to be allocated to the affected investor for the calendar year pursuant to paragraph (k) of this section, and

(C) Such other information as may be specified by the forms or its instructions.

(ii) *Statement to be furnished to affected investors.* A nonpublicly offered regulated investment company shall provide to each affected investor for each calendar year (whether or not the nonpublicly offered regulated investment company is required to make an information return with respect to the affected investor pursuant to section 6042), a written statement showing the following information:

(A) The information described in paragraph (n)(1)(i) of this section with respect to the affected investor;

(B) The name and address of the nonpublicly offered regulated investment company;

(C) The name and address of the affected investor; and

(D) If the nonpublicly offered regulated investment company is required to report the amount of the affected investor's allocation of affected RIC expenses to the Internal Revenue Service pursuant to paragraph (n)(1)(i) of this section, a statement to that effect.

(iii) *Affected investor's shares held by a nominee.* If an affected investor's shares in a nonpublicly offered regulated investment company are held in the name of a nominee, the nonpublicly offered regulated investment company may make the information return described in paragraph (n)(1)(i) of this section with respect to the nominee in lieu of the affected investor and may provide the written statement described in paragraph (n)(1)(ii) of this section to such nominee in lieu of the affected investor.

(2) *By a nominee*—(i) *In general.* Except as otherwise provided for in paragraph (n)(2)(iii) of this section, in any case in which a nonpublicly offered regulated investment company provides, pursuant to paragraph (n)(1)(iii) of this section, a written statement to the nominee of an affected investor for a calendar year, the nominee shall—

(A) If the nominee is required to make an information return pursuant to section 6042 (or would be required to make an information return but for the $10 threshold described in section 6042(a)(1)(A) and (B)), make an information return (*e.g.*, Form 1099-DIV, Dividends and Distributions, for 1987) for the calendar year with respect to each affected investor and state separately on such information return the information described in paragraph (n)(1)(i) of this section, and

(B) Furnish each affected investor with a written statement for the calendar year showing the information required by paragraph (n)(2)(ii) of this section (whether or not the nominee is required to make an information return with respect to the affected investor pursuant to section 6042).

(ii) Form of statement. The written statement required to be furnished for a calendar year pursuant to paragraph (n)(2)(i)(B) of this section shall show the following information:

(A) The affected investor's proportionate share of the items described in paragraph (n)(1)(i) of this section for the calendar year,

(B) The name and address of the nominee,

(C) The name and address of the affected investor, and

(D) If the nominee is required to report the affected investor's share of the allocable investment expenses to the Internal Revenue Service pursuant to paragraph (n)(2)(i)(A) of this section, a statement to that effect.

(iii) *Return not required.* A nominee is not required to make an information return with respect to an affected investor pursuant to paragraph (n)(2)(i)(A) of this section if the nominee is excluded from the requirements of section 6042 pursuant to §1.6042-2(a)(1)(ii) or (iii).

(iv) *Statement not required.* A nominee is not required to furnish a written statement to an affected investor pursuant to paragraph (n)(2)(i)(B) of this section if the nonpublicly offered regulated investment company furnishes the written statement to the affected investor pursuant to an agreement with the nominee described in §1.6042-2(a)(1)(iii).

(v) *Special rule.* Paragraph (n)(1)(i) and (ii) of this section applies to a nonpublicly offered regulated investment company that agrees with the nominee to satisfy the requirements of section 6042 as described in § 1.6042-2(a)(1)(iii) with respect to the affected investor.

(3) *Time and place for furnishing returns.* The returns required by paragraph (n)(1)(i) and (2)(i)(A) of this section for any calendar year shall be filed at the time and place that a return required under section 6042 is required to be filed. See §1.6042-2(c).

(4) *Time for furnishing statements.* The statements required by paragraph (n)(1)(ii) and (2)(i)(B) of this section to be furnished by a nonpublicly offered regulated investment company and a nominee, respectively, to an affected investor for a calendar year shall be furnished to such affected investor on or before January 31 of the following year.

(5) *Duplicative returns and statements not required*—(i) *Information return.* The requirements of paragraph (n)(1)(i) and (2)(i)(A) of this section for the making of an information return shall be met by the timely filing of an information return pursuant to section 6042 that contains the information required by paragraph (n)(1)(i).

(ii) *Written statements.* The requirements of paragraph (n)(1)(ii) and (2)(i)(B) of this section for the furnishing of a written statement (including the statement required by paragraph (n)(1)(ii)(D) and (2)(ii)(D) of this section) shall be met by furnishing the affected investor a copy of the information return to which section 6042 applies (whether or not the nonpublicly offered regulated investment company or nominee is required to file an information return with respect to the affected investor pursuant to section 6042) that contains the information required by paragraph (n)(1)(ii) or (2)(ii), whichever is applicable, of this section. Nonpublicly offered regulated investment companies and nominees may use a substitute form that contains provisions substantially similar to those of the prescribed form if the nonpublicly offered regulated investment company or nominee complies with all revenue procedures relating to substitute forms in effect at the time. The statement shall be furnished either in person or in a statement mailed by first-class mail that includes adequate notice that the statement is enclosed. A statement shall be considered to be furnished to an affected investor within the meaning of this section if it is mailed to such affected investor at its last known address.

(o) *Return of information by a common trust fund.* With respect to each affected investor to which paragraph (d) of this section applies, the common trust fund shall state on the return it is required to make pursuant to section 6032 for its taxable year, the following information:

(1) The amount of the affected investor's proportionate share of the affected expenses for the taxable year as described in paragraph (d)(1)(ii) of this section,

(2) The amount of the affected investor's proportionate share of ordinary taxable income or ordinary net loss for the taxable year determined pursuant to paragraph (d)(1)(i) of this section, and

(3) Such other information as may be specified by the forms or its instructions.

(p) *Publicly offered regulated investment companies.* [Reserved]

* * * * *

§1.67-4T Allocation of expenses by nongrantor trusts and estates (temporary). [Reserved]

Par. 4. Paragraph (b) of §1.162-1 is amended by adding a new subparagraph (7) immediately following subparagraphs (6) to read as set forth below:

§ 1.162-1 Business expenses.

* * * * *

(b) *Cross references.* * * *

(7) For limitations on the deductibility of miscellaneous itemized deductions, see section 67 and §§1.67-1T through 1.67-4T.

PART 602 OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 5. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 6. Paragraph (c) of §602.101 is amended by inserting in the appropriate place in the table "§1.67-2T . . . 1545-0110".

There is a need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue it with notice and public procedure under subsection (b) of section 553 of title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved March 8, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 25, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 28, 1988, 53 F.R. 9870)

---

26 CFR 1.67-3T: Allocation of expenses by real estate mortgage investment conduits (temporary).

T.D. 8186

TITLE 26.—INTERNAL REVENUE—CHAPTER 1, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; SUBCHAPTER H, PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Election to be Taxed as a Real Estate Mortgage Investment Conduit and Other Administrative Matters

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary income tax regulations relating to real estate mortgage investment conduits. The relevant provisions in the Internal Revenue Code were added or amended by the Tax Reform Act of 1986. These regulations prescribe the manner in which an entity elects status as a real estate mortgage investment conduit

(REMIC) for Federal income tax purposes and the procedures to be followed when filing a Federal income tax return as a REMIC. The regulations also require a REMIC to file information returns with the Internal Revenue Service and to provide notice to holders of interests in the REMIC of income and certain allocable expenses attributable to their interests.

DATES: The temporary regulations are effective after December 31, 1986, and, with respect to certain reporting requirements contained in §§1.67-3T(f)(3)(ii), 1.67-3T(f)(5)(i)(B), 1.860F-4T(e)(1)(i)(D) and (E), 1.6049-7T(f)(2)(ii)(C), (D), and (G), and 1.6049-7T(f)(3), for calendar quarters and calendar years after 1987.

SUPPLEMENTARY INFORMATION

BACKGROUND

This document adds new temporary regulations to the Income Tax Regulations (26 CFR Part 1) under sections 67, 860D, 860F, and 6049(d)(7) of the Internal Revenue Code of 1986 (Code), relating to real estate mortgage investment conduits. Section 671 of the Tax Reform Act of 1986 (the 1986 Act) added to the Code new sections 860A through 860G to provide rules relating to real estate mortgage investment conduits, or REMICs, while section 674 of the 1986 Act amended section 6049 to impose certain information reporting requirements with respect to REMIC interests and certain other debt instruments. In general, a REMIC is a fixed pool of mortgages in which multiple classes of interests are held by investors and which elects to be taxed as a REMIC. The temporary regulations under section 860D prescribe the manner in which an entity elects status as a REMIC. The temporary regulations under section 860F govern the filing of a REMIC's income tax return and, together with the temporary regulations under section 6049, require that the REMIC provide notice of income and other information to its investors and the Internal Revenue Service.

Section 132 of the 1986 Act added to the Code new section 67 which disallows certain miscellaneous itemized deductions in computing the taxable income of an individual to the extent that the aggregate of those deductions does not exceed 2 percent of the individual's adjusted gross income. Section 67(c) directs that regulations be issued to prohibit the indirect deduction through pass-through entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual. Section 67(c) also directs that regulations provide any necessary reporting requirements. The temporary regulations under section 67 that are contained in this document fulfill the requirements of section 67(c) as it applies to REMICs.

Under section 675(a) of the 1986 Act, new sections 860A through 860G of the Code and the conforming amendments made to other sections are effective for taxable years beginning after December 31, 1986. Section 106(v)(1) of the Technical Corrections Bill would amend section 675(a) of the 1986 Act so that all provisions relating to REMICs take effect as of January 1, 1987. Accordingly, the Service has announced that it will apply these provisions to any holder of an interest in a REMIC as of January 1, 1987, regardless of the holder's taxable year. See Notice 87-41, 1987-1 C.B. 500.

EXPLANATION OF PROVISIONS

Treatment of a REMIC as a partnership

Section 860F(e) provides that, for purposes of subtitle F of the Code (Procedure and Administration), a REMIC is treated as a partnership and any holder of a residual interest is treated as a partner. Thus, the rules relating to the tax treatment of partnership items (subchapter C of chapter 63 of subtitle F) generally apply to a REMIC. For example, under §1.860F-4T(d), a REMIC may designate a tax matters person in the same manner in which a partnership may designate a tax matters partner under §301.6231(a)(7)-1T. If there is only one holder of the REMIC residual interest, however, §1.860F-4T(a) provides an exception to the application of those rules.

REMIC income tax return and election

Section 1.860F-4T(b) generally requires a REMIC to file an income tax return annually with the Internal Revenue Service. The Service has developed new Form 1066, U.S. Real Estate Mortgage Investment Conduit Income Tax Return, for this purpose. As required by section 860F(e), the return must include the amount of the daily accruals determined under section 860E(c). The due date and any extensions for filing the REMIC's annual return are determined as if the REMIC were a partnership that uses the calendar year. Form 1066 may be signed by any one of the holders of a residual interest during that taxable year or, as provided in section 6903, by a fiduciary as defined in section 7701(a)(6).

As provided in §1.860D-1T(a), an entity or a segregated pool of assets within an entity elects to be treated as a REMIC by furnishing certain information and by computing its taxable income (or net loss) as a REMIC in accordance with section 860C(b) and the regulations thereunder. This election is made on the Form 1066 for the first taxable year of the entity's existence. Once made, the election is irrevocable for that taxable year and all succeeding taxable years.

Section 1.860D-1T(b) requires that the REMIC provide certain information with its income tax return for the year of the election. That information includes the REMIC's employer identification number (a REMIC may apply for an EIN on Form SS-4, "Application for Employer Identification Number"), information concerning the terms of each class of regular interest and the designated residual interest, and any other information that is required by the form. The REMIC must also provide on its first return a description of the prepayment and reinvestment assumptions that are made pursuant to section 1272(a)(6). Finally, under §1.860D-1T(c), an entity or segregated pool of assets that elects to be a REMIC must keep sufficient records concerning investments and other assets to be able to show that it is in compliance with the provisions of sections 860A through 860G during each taxable year.

Notice to residual interest holders

At the close of each calendar quarter, a REMIC is required under §1.860F-4T(e)(1) to provide to each person who held a residual interest in the REMIC during the quarter notice on Schedule Q (Form 1066) of certain information. That information includes (a) the residual holder's share of REMIC taxable income or net loss for the calendar quarter, (b) the amount of the excess inclusion with respect to the holder's residual interest, (c) in the case of certain holders, the allocable investment expenses for the quarter, (d) for calendar years after 1987, certain information with respect to the percentage of the REMIC's assets that are qualifying real property loans under section 593, assets of a domestic building and loan association (as described in section 7701(a)(19)), and real estate assets under §1.860F-4T(e)(1)(ii)(C). The requirements concerning real estate assets under section 856 anticipate certain provisions of the Technical Corrections Bill amending the 1986 Act.

Generally, §1.860F-4T(e)(2) requires that Schedule Q be mailed (or otherwise delivered) to each holder of a residual interest during a calendar quarter no later than the last day of the month following the close of the calendar quarter. Under §1.860F-4T(e)(2)(ii), however, the notice for each of the four calendar quarters of 1987 must be mailed (or otherwise delivered) to each holder no later than March 28, 1988. Finally, §1.860F-4T(e)(4) provides that a copy of Schedule Q for each person who was a residual interest holder at any time during a REMIC's taxable year and for each quarter in which that person was a residual interest holder must be attached to the REMIC's income tax return for that taxable year. Quarterly notice to the Internal Revenue Service is not required.

Reporting to regular interest holders

Section 6049 of the Code requires that certain returns of information be made regarding payments of interest. Under section 6049(d)(7) and §1.6049-7T(a), the term "interest" includes amounts includible in the gross income of any holder of a REMIC regular interest or any other debt instrument to which section 1272(a)(6) applies. In accordance with Notice 87-41, this expanded definition of the term "interest" is effective, for purposes of section 6049(a), with respect to any REMIC regular interest or any other debt instrument to which section 1272(a)(6) applies that is issued after December 31, 1986.

As required by §1.6049-7T(b)(1), an information return must be made with respect to any amount aggregating $10 or more that is includible as interest under §1.6049-7T(a). This return must be made by any REMIC or other issuer of a debt instrument to which section 1272(a)(6) applies and by any broker or middleman who holds as a nominee any REMIC regular interest or any other debt instrument to which section 1272(a)(6) applies. Under §1.6049-7T(c), information returns are not required to be made with respect to amounts includible as interest by certain holders.

In the case of an amount includible as interest, other than original issue discount, §1.6049-7T(b)(3)(i) requires that the information return be made on Form 1099 for each calendar year showing the aggregate amount includible, the name, address, and taxpayer identification number of the person in whose income this amount is includible, and such other information as is required by the form. Section 1.6049-7T(b)(3)(ii) requires similar information with respect to amounts of original issue discount includible by any holder of a REMIC regular interest or any other debt instrument to which section 1272(a)(6) applies.

The information returns required under §1.6049-7T are to be filed annually in the manner prescribed in paragraph (e) of that section. Generally, §1.6049-7T(f) requires that the same information that is provided to the Service also be furnished to each person in whose income amounts are includible as interest. Under §1.6049-7T(f)(3), certain information regarding REMIC assets must also be provided to investors. The additional information specified in §§1.67-3T(f)(3)(ii), 1.6049-7T(f)(2)(ii)(C), (D) and (G), and 1.6049-7T(f)(3) shall be furnished to investors for calendar years after 1987.

The Service is interested in comments on possible alternatives that would simplify the reporting requirements to holders of REMIC regular interests by brokers and middlemen who hold as nominees. These comments should address the cost and administrability of any suggested alternative methods.

Information required on debt instrument

Under §1.6049-7T(g), the issuer of any REMIC regular interest or any other debt instrument to which section 1272(a)(6) applies is required to set forth certain information on the face of the regular interest or other debt instrument. This requirement is effective, however, only with respect to any regular interest or other debt instrument that is ussed after April 8, 1988.

Treatment of allocable investment expenses

Section 1.67-3T(a)(1) requires a REMIC to allocate to each of its pass-through interest holders the holder's proportionate share of the aggregate amount of allocable investment expenses of the REMIC for the calendar quarter. In general, a pass-through interest holder (as defined in §1.67-3T(a)(2)(i)(A)) is any holder of a residual interest that is either an individual (other than certain nonresident aliens), a person that computes its taxable income in the same manner as in the case of an individual, or a pass-through entity, interests in which are owned by either an individual or a person that computes its taxable income in the same manner as in the case of an individual.

The term "pass-through interest holder" includes, pursuant to §1.67-3T(a)(3)(i), a grantor trust, a partnership, an S corporation, a common trust fund, a regulated investment company, and a REMIC. It does not include an estate, a nongrantor trust, a cooperative, a real estate investment trust, or other entities such as a qualified pension plan, an individual retirement account, or an insurance company holding assets in a separate asset account to fund certain variable contracts. The term "allocable investment expenses" (as defined in §1.67-3T(a)(4)) means the aggregate amount of the expenses paid or accrued in the calendar quarter for which a deduction is allowable under section 212 in determining the taxable income of the REMIC for the calendar quarter.

Pursuant to §1.67-3T(b)(1) a pass-through interest holder is treated both as having received or accrued income and as having paid or incurred an expense described in section 212 (or section 162 in the case of a pass-through interest holder that is a regulated investment company) in an amount equal to the pass-through interest holder's proportionate share of the allocable investment expenses of the REMIC. Under §1.67-3T(b)(1)(i), a pass-through interest holder whose taxable year is the calendar year or ends with a calendar quarter takes into account such amounts in those calendar quarters that fall within the holder's taxable year. Separate inclusion rules apply under §1.67-3T(b)(1)(ii) to a holder whose taxable year does not end with a calendar quarter. An interest holder in a REMIC that is not a pass-through interest holder does not take into account in computing its taxable income any amount of its proportionate share of allocable investment expenses.

Under §1.67-3T(c)(1), a REMIC generally computes a pass-through interest holder's proportionate share of its allocable investment expenses by determining the daily amount of such expenses and allocating this daily amount to the pass-through interest holder in proportion to its respective holdings on that day. Generally, a pass-through interest holder's proportionate share of the daily amount of the allocable investment expenses is determined by taking into account all holders of a REMIC residual interest, whether or not pass-through interest holders.

A REMIC is required under §1.67-3T(f)(1) to provide written notice to each pass-through interest holder to whom an allocation of expenses is required to be made. Except in the case of notice to a regular interest holder in a single-class REMIC (as described in §1.67-3T(a)(2)(ii)(B)), notice is furnished quarterly on Schedule Q (Form 1066). The notice must list the aggregate amount of expenses paid or accrued during each calendar quarter for which the REMIC is allowed a deduction under section 212 and the interest holder's proportionate share of these expenses for the calendar quarter. This information must also be furnished annually by the REMIC to the Internal Revenue Service pursuant to §1.67-3T(f)(3)(i).

If a pass-through interest holder's interest in a REMIC is held in the name of a nominee, the REMIC may provide the written notice to the nominee and make the information return to the Internal Revenue Service with respect to the nominee. Section 1.67-3T(f)(5) provides reporting requirements for nominees to which a REMIC provides notice.

In the case of a single-class REMIC, the term "pass-through interest holder" is defined more broadly to include any regular or residual interest holder that is either an individual (other than certain nonresident aliens), a person that computes its taxable income in the same manner as in the case of an individual, or a pass-through entity, interests in which are owned by certain types of holders. Under §1.67-3T(c)(3), a single-class REMIC allocates its investment expenses for a calendar quarter to each holder in proportion to the amount of income that accrues to the holder for that quarter.

As required under §1.67-3T(f) for all other REMICs, a single-class REMIC must report to pass-through interest holders and the Internal Revenue Service the holder's proportionate share of allocable investment expenses. Such a REMIC is required to report this information quarterly to pass-through interest holders who hold residual interests on Schedule Q (Form 1066) and annually to the Internal Revenue Service as required in §1.860F-4T(e)(4). A single-class REMIC is required to report the information quarterly to pass-through interest holders who hold regular interests on a separate statement and annually to the Internal Revenue Service on information return Form 1099.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that these temporary regulations do not constitute a major rule as defined in Executive Order 12291 and, therefore, a regulatory impact analysis is not required.

No general notice of proposed rulemaking is required by 5 U.S.C. 553(d) for temporary regulations. Accordingly, the Regulatory Flexibility Act (5 U.S.C. Chapter 6) does not apply and no Regulatory Flexibility Analysis is required for this rule.

The collection of information requirements added by this document have been submitted to the Office of Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduction Act of 1980. These requirements have been approved by OMB

* * * * *

Adoption of amendments to the regulations.

Accordingly, 26 CFR Parts 1 and 602 are amended as follows:

INCOME TAX REGULATIONS
PART 1

Paragraph 1. The authority for Part 1 is amended by adding the following citations:

Authority: 26 U.S.C. 7805. *** §1.67-3T also issued under 26 U.S.C. 67(c). *** §1.860F-4T also issued under 26 U.S.C. 860G(c)(3). *** §1.6049-7T also issued under 26 U.S.C. 1275(c) and 26 U.S.C. 6049(d)(7)(D). ***

Par. 2. New §1.67-3T is added in the appropriate place and reads as set forth below:

§1.67-3T Allocation of expenses by real estate mortgage investment conduits (temporary).

(a) *Allocation of allocable investment expenses*—(1) *In general.* A real estate mortgage investment conduit or REMIC (as defined in section 860D) shall allocate to each of its pass-through interest holders that holds an interest at any time during the calendar quarter the holder's proportionate share (as determined under paragraph (c) of this section) of the aggregate amount of allocable investment expenses of the REMIC for the calendar quarter.

(2) *Pass-through interest holder*—(i) *In general*—(A) *Meaning of term.* Except as provided in paragraph (a)(2)(ii) of this section, the term "pass-through interest holder" means any holder of a REMIC residual interest (as defined in section 860G(a)(2)) that is—

(*1*) An individual (other than a nonresident alien whose income with respect to his or her interest in the REMIC is not effectively connected with the conduct of a trade or business within the United States),

(*2*) A person, including a trust or estate, that computes its taxable income in the same manner as in the case of an individual, or

(*3*) A pass-through entity (as defined in paragraph (a)(3) of this section) if one or more of its partners, shareholders, beneficiaries, participants, or other interest holders is (*i*) a pass-through entity or (*ii*) a person described in paragraph (a)(2)(i)(A)(*1*) or (*2*) of this section.

(B) *Examples.* The provisions of this paragraph (a)(2)(i) may be illustrated by the following examples:

Examples (1). Corporation X holds a residual interest in REMIC R in its capacity as a nominee or custodian for individual A, the beneficial owner of the interst. Because the owner of the interest for Federal income tax purposes is an individual, the interest is owned by a pass-through interest holder.

Example (2). Individual retirement account I holds a residual interest in a REMIC. Because an individual retirement account is not a person described in paragraph (a)(2)(i)(A) of this section, the interest is not held by a pass-through interest holder.

(ii) *Single-class REMIC*—(A) *In general.* In the case of a single-class REMIC, the term "pass-through interest holder" means any holder of either—

(*1*) A REMIC regular interest (as defined in section 860G(a)(1)), or

(*2*) A REMIC residual interest, that is described in paragraph (a)(2)(i)(A)(*1*), (*2*), or (*3*) of this section.

(B) *Single-class REMIC.* For purposes of paragraph (a)(2)(ii)(A) of this section, a single-class REMIC is either—

(*1*) A REMIC that would be classified as an investment trust under §301.7701-4(c)(1) but for its qualification as a REMIC under section 860D and §1.860D-1T, or

(*2*) A REMIC that—

(*i*) Is substantially similar to an investment trust under §301.7701-4(c)(1), and

(*ii*) Is structured with the principal purpose of avoiding the requirement of paragraph (a)(1) and (2)(ii)(A) of this section to allocate allocable investment expenses to pass-through interest holders that hold regular interests in the REMIC.

For purposes of this paragraph (a)(2)(ii)(B), in determining whether a REMIC would be classified as an investment trust or is substantially similar to an investment trust, all interests in the REMIC shall be treated as ownership interests in the REMIC, without regard to whether or not they would be classified as debt for Federal income tax purposes in the absence of a REMIC election.

(C) *Examples.* The provisions of paragraph (a)(2)(ii) of this section may be illustrated by the following examples:

Example (1). Corporation M transfers mortgages to a bank under a trust agreement as described in Example (2) of §301.7701-4(c)(2). There are two classes of certificates. Holders of class C certificates are entitled to receive 90 percent of the payments of principal and interest on the mortgages; holders of class D certificates are entitled to receive the remaining 10 percent. The two classes of certificates are identical except that, in the event of a default on the underlying mortgages, the payment rights of class D certificate holders are subordinated to the rights of class C certificate holders. M sells the class C certificates to investors and retains the class D certificates. The trust would be classified as an investment trust under §301.7701-4(c)(1) but for its qualification as a REMIC under section 860D. The class C certificates represent regular interests in the REMIC and the class D certificates represent residual interests in the REMIC. The REMIC is a single-class REMIC within the meaning of paragraph (a)(2)(ii)(B)(*1*) of this section and, accordingly, holders of both the class C and class D certificates who are described in paragraph (a)(2)(i)(A)(*1*), (*2*), or (*3*) of this section are treated as pass-through interest holders.

Example (2). Assume that the facts are the same as in Example (1) except that M structures the REMIC to include a second regular interest represented by class E certificates. The principle purpose of M in structuring the REMIC to include class E certificates is to avoid allocating allocable investment expenses to class C certificate holders. The class E certificate holders are entitled to receive the payments otherwise due the class D certificate holders until they have been paid a stated amount of principal plus interest. The fair market value of the class E certificate is ten percent of the fair market value of the class D certificate and, therefore, less than one percent of the fair market value of the REMIC. The REMIC would not be classified as an investment trust under §301.7701-4(c)(1) because the existence of the class E certificates is not incidental to the trust's purpose of facilitating direct investment in the assets of the trust. Nevertheless, because the fair market value of the class E certificates is de minimis, the REMIC is substantially similar to an investment trust under §301.7701-4(c)(1). In addition, avoidance of the requirement to allocate allocable investment expenses to regular interest holders is the principle purpose of M in structuring the REMIC to include class E certificates. Therefore, the REMIC is a single-class REMIC within the meaning of paragraph (a)(2)(ii)(B)(*2*) of this section, and, accordingly, holders of both residual and regular interests who are described in paragraph (a)(2)(i)(A)(*1*), (*2*), or (*3*) of this section are treated as pass-through interest holders.

(3) *Pass-through entity*—(i) *In general.* Except as provided in paragraph (a)(3)(ii) of this section, for purposes of this section, a pass-through entity is—

(A) A trust (or any portion thereof) to which subpart E, part 1, subchapter J, chapter 1 of the Code applies,

(B) A partnership,

(C) An S corporation,

(D) A common trust fund described in section 584,

(E) A nonpublicly offered regulated investment company (as defined in paragraph (a)(5)(i) of this section),

(F) A REMIC, and

(G) Any other person—

(*1*) Which is not subject to income tax imposed by subtitle A, chapter 1, or which is allowed a deduction in computing such tax for distributions to owners or beneficiaries, and

(*2*) The character of the income of which may affect the character of the income recognized with respect to that person by its owners or beneficiaries.

Entities that do not meet the requirements of paragraph (a)(3)(i)(G)(*1*) and (*2*), such as qualified pension plans, individual retirement accounts, and insurance companies holding assets in separate asset accounts to fund variable contracts defined in section 817(d), are not described in this paragraph (a)(3)(i).

(ii) *Exception.* For purposes of this section, a pass-through entity does not include—

(A) An estate,

(B) A trust (or any portion thereof) not described in paragraph (a)(3)(i)(A) of this section,

(C) A cooperative described in section 1381(a)(2), determined without regard to subparagraphs (A) and (C) thereof, or

(D) A real estate investment trust.

(4) *Allocable investment expenses.* The term "allocable investment expenses" means the aggregate amount of the expenses paid or accrued in the calendar quarter for which a deduction is allowable under section 212 in determining the taxable income of the REMIC for the calendar quarter.

(5) *Nonpublicly offered regulated investment company*—(i) *In*

general. For purposes of this section, the term "nonpublicly offered regulated investment company" means a regulated investment company to which part I of subchapter M of the Code applies that is not a publicly offered regulated investment company.

(ii) *Publicly offered regulated investment company.* For purposes of this section, the term "publicly offered regulated investment company" means a regulated investment company to which part I of subchapter M of the Code applies, the shares of which are—

(A) Continuously offered pursuant to a public offering (within the meaning of section 4 of the Securities Act of 1933, as amended (15 U.S.C. 77a to 77aa)),

(B) Regularly traded on an established securities market, or

(C) Held by or for no fewer than 500 persons at all times during the taxable year.

(b) *Treatment of allocable investment expenses*—(1) *By pass-through interest holders*—(i) *Taxable year ending with calendar quarter.* A pass-through interest holder whose taxable year is the calendar year or ends with a calendar quarter shall be treated as having—

(A) Received or accrued income, and

(B) Paid or incurred an expense described in section 212 (or section 162 in the case of a pass-through interest holder that is a regulated investment company), in an amount equal to the pass-through interest holder's proportionate share of the allocable investment expenses of the REMIC for those calendar quarters that fall within the holder's taxable year.

(ii) *Taxable year not ending with calendar quarter.* A pass-through interest holder whose taxable year does not end with a calendar quarter shall be treated as having—

(A) Received or accrued income, and

(B) Paid or incurred an expense described in section 212 (or section 162 in the case of a pass-through interest holder that is a regulated investment company), in an amount equal to the sum of—

(C) The pass-through interest holder's proportionate share of the allocable investment expenses of the REMIC for those calendar quarters that fall within the holder's taxable year, and

(D) For each calendar quarter that overlaps the beginning or end of the taxable year, the sum of the daily amounts of the allocable investment expenses allocated to the holder pursuant to paragraph (c)(1)(ii) of this section for the days in the quarter that fall within the holder's taxable year.

(2) *Proportionate share of allocable investment expenses.* For purposes of paragraph (b) of this section, a pass-through interest holder's proportionate share of the allocable investment expenses is the amount allocated to the pass-through interest holder pursuant to paragraph (a)(1) of this section.

(3) *Cross-reference* See §1.67-1T with respect to limitations on deductions for expenses described in section 212 (including amounts treated as such expenses under this section).

(4) *Interest income to holders of regular interests in certain REMICs.* Any amount allocated under this section to the holder of a regular interest in a single-class REMIC (as described in paragraph (a)(2)(ii)(B) of this section) shall be treated as interest income.

(5) *No adjustment to basis.* The basis of any holder's interest in a REMIC shall not be increased or decreased by the amount of the holder's proportionate share of allocable investment expenses.

(6) *Interest holders other than pass-through interest holders.* An interest holder of a REMIC that is not a pass-through interest holder shall not take into account in computing its taxable income any amount of income or expense with respect to its proportionate share of allocable investment expenses.

(c) *Computation of proportionate share*—(1) *In general.* For purposes of paragraph (a)(1) of this section, a REMIC shall compute a pass-through interest holder's proportionate share of the REMIC's allocable investment expenses by—

(i) Determining the daily amount of the allocable investment expenses for the calendar quarter by dividing the total amount of such expenses by the number of days in that calendar quarter,

(ii) Allocating the daily amount of the allocable investment expenses to the pass-through interest holder in proportion to its respective holdings on that day, and

(iii) Totaling the interest holder's daily amounts of allocable investment expenses for the calendar quarter.

(2) *Other holders taken into account.* For purposes of paragraph (c)(1)(ii) of this section, a pass-through interest holder's proportionate share of the daily amount of the allocable investment expenses is determined by taking into account all holders of residual interests in the REMIC, whether or not pass-through interest holders.

(3) *Single-class REMIC*—(i) *Daily allocation.* In lieu of the allocation specified in paragraph (c)(1)(ii) of this section, a single-class REMIC (as described in paragraph (a)(2)(ii)(B) of this section) shall allocate the daily amount of the allocable investment expenses to each pass-through interest holder in proportion to the amount of income accruing to the holder with respect to its interest in the REMIC on that day.

(ii) *Other holders taken into account.* For purposes of paragraph (c)(3)(i) of this section, the amount of the allocable investment expenses that is allocated on any day to each pass-through interest holder shall be determined by multiplying the daily amount of allocable investment expenses (determined pursuant to paragraph (c)(1)(i) of this section) by a fraction, the numerator of which is equal to the amount of income that accrues (but not less than zero) to the pass-through interest holder on that day and the denominator of which is the total amount of income (as determined under paragraph (c)(3)(iii) of this section) that accrues to all regular and residual interest holders, whether or not pass-through interest holders, on that day.

(iii) *Total income accruing.* The total amount of income that accrues to all regular and residual interest holders is the sum of—

(A) The amount includible under section 860B in the gross income (but not less than zero) of the regular interest holders, and

(B) The amount of REMIC taxable income (but not less than zero) taken into account under section 860C by the residual interest holders.

(4) *Dates of purchase and disposition.* For purposes of this section, a pass-through interest holder holds an interest on the date of its purchase but not on the date of its disposition.

(d) *Example.* The provisions of this section may be illustrated by the following example:

Example. (i) During the calendar quarter ending March 31, 1989, REMIC X, which is not a single-class REMIC, incurs $900 of allocable investment expenses. At the beginning of the calendar quarter, X has 4 residual interest holders, who hold equal proportionate shares, and 10 regular interest holders. The residual interest holders, all of whom have calendar-year taxable years, are as follows:

A, an individual

C, a C corporation that is a nominee for individual I,

S, an S corporation, and

M, a C corporation that is not a nominee.

(ii) Except for A, all of the residual interest holders hold their interests in X for the entire calendar quarter. On January 31, 1989, A sells his interest to S. Thus, for the first month of the calendar quarter, each residual interest holder holds a 25 percent interest (100%/4 interest holders) in X. For the last two months, S's holding is increased to 50 percent and A's holding is decreased to zero. The daily amount of allocable investment expenses for the calendar quarter is $10 ($900/90 days).

(iii) The amount of allocable investment expenses apportioned to the residual interest holders is as follows:

(A) $75 ($10 × 25% × 30 days) is allocated to A for the 30 days that A holds an interest in X during the calendar quarter. A includes $75 in gross income in calendar year 1989. The amount of A's expenses described in section 212 is increased by $75 in calendar year 1989. A's deduction under section 212 (including the $75 amount of the allocation) is subject to the limitations contained in section 67.

(B) $225 ($10 × 25% × 90 days) is allocated to C. Because C is a nominee for I, C does not include $225 in gross income or increase its deductible expenses by $225. Instead, I includes $225 in gross income in calendar year 1989, her taxable year. The amount of I's expenses described in section 212 is increased by $225. I's deduction under section 212 (including the $225 amount of the allocation) is subject to the limitations contained in section 67.

(C) $375 (($10 × 25% × 30 days) + ($10 × 50% × 60 days)) is allocated to S. S includes in gross income $375 of allocable investment expenses in calendar year 1989. The amount of S's expenses described in section 212 for that taxable year is increased by $375. S allocates the $375 to its shareholders in accordance with the rules described in sections 1366 and 1377 in calendar year 1989. Thus, each shareholder of S includes its pro rata share of the $375 in gross income in its taxable year in which or with which calendar year 1989 ends. The amount of each shareholder's expenses described in section 212 is increased by the amount of the shareholder's allocation for the shareholder's taxable year in which or with which calendar year 1989 ends. The shareholder's deduction under section 212 (including the allocation under this section) is subject to the limitations contained in section 67.

(D) No amount is allocated to M. However, M's interest is taken into account for purposes of determining the proportionate share of those residual interest holders to whom an allocation is required to be made.

(iv) No allocation is made to the 10 regular interest holders pursuant to paragraph (a) of this section. In addition, the interests held by these interest holders are not taken into account for purposes of determining the proportionate share of the residual interest holders to whom an allocation is required to be made.

(e) *Allocable investment expenses not subject to backup withholding.* The amount of allocable investment expenses required to be allocated to a pass-through interest holder pursuant to paragraph (a)(1) of this section is not subject to backup withholding under section 3406.

(f) *Notice to pass-through interest holders*—(1) *Information required.* For each calendar quarter, a REMIC shall provide to each pass-through interest holder to which an allocation of allocable investment expenses is required to be made pursuant to paragraph (a)(1) of this section notice of—

(i) The aggregate amount of expenses paid or accrued during the calendar quarter for which the REMIC is allowed a deduction under section 212, and

(ii) The proportionate share of these expenses allocated to that pass-through interest holder for the calendar quarter, as determined under paragraph (c) of this section.

(2) *Statement to be furnished*—(i) *To residual interest holder.* For each calendar quarter, a REMIC shall provide to each pass-through interest holder who holds a residual interest during the calendar quarter the notice required under paragraph (f)(1) of this section on Schedule Q (Form 1066), as required in §1.860F-4T(e).

(ii) *To regular interest holder*—(A) *In general.* For each calendar quarter, a single-class REMIC (as described in paragraph (a)(2)(ii)(B) of this section) generally shall provide to each pass-through interest holder who holds a regular interest during the calendar quarter the notice required under paragraph (f)(1) of this section on a separate statement mailed (or otherwise delivered) in a separate mailing to the regular interest holder's last known address no later than the last day of the month following the close of the calendar quarter. No promotional or advertising information may be included on the statement. The information required to be included in the notice for the last calendar quarter of the calendar year may, however, be separately stated on the statement described in §1.6049-7T(f) instead of on a separate statement provided in a separate mailing. See §1.6049-7T(f)(4) and (6)(i)(A).

(B) *Special rule for 1987.* The statement required under paragraph (f)(2)(ii)(A) of this section for any calendar quarter of 1987 shall be mailed (or otherwise delivered) to each pass-through interest holder who holds a regular interest during that calendar quarter no later than March 28, 1988.

(3) *Returns to the Internal Revenue Service*—(i) *With respect to residual interest holders.* Any REMIC required under paragraph (f)(1) and (2)(i) of this section to furnish information to any pass-through interest holder who holds a residual interest shall also furnish such information to the Internal Revenue Service as required in §1.860F-4T(e)(4).

(ii) *With respect to regular interest holders.* A single-class REMIC (as described in paragraph (a)(2)(ii)(B) of this section) shall make an information return on Form 1099 for each calendar year beginning after December 31, 1987, with respect to each pass-through interest holder who holds a regular interest to which an allocation of allocable investment expenses is required to be made pursuant to paragraph (a)(1) and (2)(ii) of this section and for which the REMIC is required to make an information return to the Internal Revenue Service pursuant to section 6049 and §1.6049-7T(b)(2)(i) (or would be required to make such information return but for the $10 threshold described in section 6049(a)(1) and §1.6049-7T(b)(1)). The REMIC shall state on the information return—

(A) The sum of—

(*1*) The aggregate amounts includible in gross income as interest (as defined in §1.6049-7T(a)(2)(i) and (ii)), for the calendar year, and

(*2*) The sum of the amount of allocable investment expenses required to be allocated to the pass-through interest holder for each calendar quarter during the calendar year pursuant to paragraph (a) of this section, and

(B) Such other information as may be specified by the form or its instructions.

(4) *Pass-through interest holder's interest held by a nominee.* If a pass-through interest holder's interest in a REMIC is held in the name of a nominee, the REMIC may make the information return described in paragraph (f)(3)(i) and (ii) of this section with respect to the nominee in lieu of the pass-through interest holder and may provide the written statement decribed in paragraph (f)(2)(i) and (ii) of this section to such nominee in lieu of the pass-through interest holder.

(5) *Nominee reporting*—(i) *In general.* In any case in which a REMIC provides, pursuant to paragraph (f)(4) of this section, a written statement to the nominee of the pass-through interest holder for a calendar quarter—

(A) The nominee shall furnish each pass-through interest holder with a written statement described in either paragraph (f)(2)(i) or (ii) of this section, whichever is applicable, for the calendar quarter showing the information described in paragraph (f)(1) of this section, and

(B) If—

(*1*) The nominee is a nominee for a pass-through interest holder who holds a regular interest in a single-class REMIC (as described in paragraph (a)(2)(ii)(B) of this section), and

(*2*) The nominee is required to make an information return pursuant to section 6042 and §1.6049-7T(b)(1) and (2)(ii) (or would be required to make an information return but for the $10 threshold described in section 6049(a)(2) and §1.6049-7T(b)(1)) with respect to the pass-through interest holder,

the nominee shall make an information return on Form 1099 for each calendar year beginning after December 31, 1987, with respect to the pass-through interest holder and state on this information return the information described in paragraph (f)(3)(ii)(A) and (B) of this section.

(ii) *Time for furnishing statement.* The statement required by paragraph (f)(5)(i)(A) of this section to be furnished by a nominee to a pass-through interest holder for a calendar quarter shall be furnished to this holder no later than 30 days after receiving the written statement described in paragraph (f)(2)(i) or (ii) of this section from the REMIC.

(6) *Special rules*—(i) *Time and place for furnishing returns.* The return required by paragraph (f)(3)(ii) and (5)(i)(B) of this section for any calendar year shall be filed at the time and place that a return required under section 6049 and §1.6049-7T(b) is required to be filed. See §1.6049-4(g) and §1.6049-7T(e).

(ii) *Duplicative returns not required.* The requirements of paragraph (f)(3)(ii) and (5)(i)(B) of this section for the making of an information return shall be met by the timely filing of an information return pursuant to section 6049 and §1.6049-7T(b) that contains the information required by paragraph (f)(2)(ii) of this section.

Par. 3. New §§1.860D-1T and 1.860F-4T are added in the appropriate place. These new sections are set forth below.

§1.860D-1T Election to be treated as a real estate mortgage investment conduit (temporary).

(a) *In general.* An entity, or a segregated pool of assets within an entity, shall elect to be treated as a REMIC by complying with the requirements of paragraph (b) of this section and computing taxable income as a REMIC on its return (as prescribed in §1.860F-4T(b)) for the first taxable year of its existence. Once made, this election is irrevocable for that taxable year and all succeeding taxable years.

(b) *Required information.* When electing to be treated as a REMIC, the entity, or segregated pool of assets within an entity, shall provide either on its return or in a separate statement attached to its return—

(1) The REMIC's employer identification number, which shall not be the same as the identification number of any other entity,

(2) Information concerning the terms and conditions of the regular interests and the designated residual interest of the REMIC, or a copy of the offering circular or prospectus containing such information,

(3) A description of the prepayment and reinvestment assumptions that are made pursuant to section 1272(a)(6) and the regulations thereunder, including a statement supporting the selection of the prepayment assumption,

(4) The form of the electing entity under State law or, if an election is being made with respect to a segregated pool of assets within an entity, the form of that latter entity under State law, and

(5) Such other information as the Commissioner may by form or revenue procedure require.

(c) *Determination of status.* An entity, or segregated pool of assets within an entity, that elects to be a REMIC shall keep sufficient records as to investments and other assets to be able to show that it has complied with the provisions of sections 860A through 860G and the regulations thereunder during each taxable year.

§1.860F-4T REMIC reporting requirements and other administrative rules (temporary).

(a) *In general.* For purposes of subtitle F of the Code, a REMIC shall be treated as a partnership and any holder of a residual interest in the REMIC shall be treated as a partner. A REMIC shall not be subject, however, to the rules of subchapter C of chapter 63 of subtitle F, relating to the treatment of partnership items, for a taxable year, if there is at no time during the taxable year more than one holder of a REMIC residual interest.

(b) *REMIC tax return*—(1) *Return of income.* To satisfy the requirement under section 6031 to make a return of income for each taxable year, a REMIC shall file the return required by paragraph (b)(2) of this section. The due date and any extensions for filing the REMIC's annual return shall be determined as if the REMIC were a partnership.

(2) *Income tax return.* Because a REMIC, unlike a partnership, may be liable for taxes imposed under subtitle A of the Code (for example, the tax imposed under section 860F(a) on net income from prohibited transactions), the REMIC shall make a return, as required by section 6011(a), for each taxable year on Form 1066, U.S. Real Estate Mortgage Investment Conduit Income Tax Return. The return shall include—

(i) The amount of principal outstanding on each class of regular interests as of the close of the taxable year,

(ii) The amount of the daily accruals determined under section 860E(c),

(iii) The REMIC's employer identification number, and

(iv) Such other information as the Commissioner may by form or revenue procedure require.

(c) *Signing of REMIC return.* For purposes of section 6063, a REMIC's income tax return for any taxable year may be signed by any one of the holders of a residual interest during that taxable year or, as provided in section 6903, by a fiduciary as defined in section 7701(a)(6) who is acting for the REMIC and who has furnished adequate notice in the manner prescribed in §301.6903-1(b)

(d) *Designation of tax matters person.* A REMIC may designate a tax matters person in the same manner in which a partnership may designate a tax matters partner under §301.6231(a)(7)-1T. For purposes of applying that section, all holders of a residual interest in the REMIC are treated as general partners.

(e) *Notice to holders of residual interests*—(1) *Information required*—(i) *In general.* At the close of each calendar quarter, a REMIC shall provide to each person who held a residual interest in the REMIC during that quarter notice on Schedule Q (Form 1066) of all the information required by the form and the information required by paragraph (e)(1)(i)(A) through (F) of this section.

(A) The REMIC shall provide to a residual interest holder that person's share of the taxable income or net loss of the REMIC for the calendar quarter.

(B) The REMIC shall provide to a residual interest holder the amount of the excess inclusion (as defined in section 860E and the regulations thereunder), if any, with respect to that person's residual interest for the calendar quarter.

(C) If the holder of a residual interest is also a pass-through interest holder (as defined in §1.67-3T(a)(2)), the REMIC shall provide to that holder the allocable investment expenses (as defined in §1.67-3T(a)(3)) for the calendar quarter.

(D) For calendar quarters after 1987, if the percentage of the REMIC's assets, computed on the basis of the average fair market value of the assets held during the calendar quarter (as described in paragraph (e)(1)(ii)(A) of this section), represented by each of the following categories:

(*1*) Qualifying real property loans under section 593,

(*2*) Assets of a domestic building and loan association (as described in section 7701(a)(19)), and

(*3*) Real estate assets as defined in paragraph (e)(1)(ii)(C) of this section,

is at least 95 percent, the REMIC shall provide a statement for each category for which the REMIC met this test, specifying that at least 95 percent of the REMIC's assets were represented by that category. If the REMIC fails to meet the 95 percent test for any category, the percentage of the REMIC's assets represented by that category shall be provided.

(E) For calendar quarters after 1987, if less than 95 percent of the assets of the REMIC are real estate assets (as defined in paragraph (e)(1)(ii)(C) of this section), the REMIC shall also provide to any real estate investment trust (REIT) that holds a residual interest the following information:

(*1*) The percentage of the REMIC's assets described in section 856(c)(5)(A), excluding from real estate assets any property (not otherwise a real estate asset) attributable to the temporary investment of new capital, computed on the bases of the average fair market value of the assets of the REMIC during the calendar quarter (as described in paragraph (e)(1)(ii)(A) of this section), and

(*2*) The percentage of the REMIC's gross income (as defined in paragraph (e)(1)(ii)(B) of this section) described in section 856(c)(3)(A) through (F), computed as of the close of the calendar quarter. For purposes of this paragraph, the term "foreclosure property" contained in section 856(c)(3)(F) shall have the meaning specified in section 860G(a)(8).

In determining whether a REIT satisfies the limitations of section 856(c)(2), all gross income shall be deemed to be derived from a source specified in section 856(c)(2).

(F) For calendar quarters in 1987, the percentages of assets required in paragraph (e)(1)(i)(D) and (E) of this section may be computed on the basis of the fair market value of the assets of the REMIC as of the close of the calendar quarter, instead of on the basis of the average during the calendar quarter.

(ii) *Special provisions.* For purposes of this paragraph (e)(1)(ii) and paragraph (e)(1)(i)(D), (E), and (F) of this section:

(A) The average fair market value of the assets during each calendar quarter is determined by making the appropriate computation as of the close of each month, week, or day, and by using the quarterly average of the monthly, weekly or daily percentages. The monthly, weekly, or daily computation period shall be applied uniformly during the calendar quarter to all categories of assets and gross income, and may not be changed in succeeding calendar quarters without the consent of the Commissioner.

(B) Gross income shall mean gross income excluding gross income from prohibited transactions defined in section 860F(a)(2).

(C) Real estate assets shall mean real estate assets as defined in section 856(c)(6)(B) excluding any property (not otherwise a real estate asset) attributable to the temporary investment of new capital.

(2) *Quarterly notice required*—(i) *In general.* Schedule Q shall be mailed (or otherwise delivered) to each holder of a residual interest during a calendar quarter no later than the last day of the month following the close of the calendar quarter.

(ii) *Special rule for 1987.* Notice to any holder of a REMIC residual interest of the information required in paragraph (e)(1) of this section for any of the four calendar quarters of 1987 shall be mailed (or otherwise delivered) to each holder no later than March 28, 1988.

(3) *Nominee reporting*—(i) *In general.* If a REMIC is required under paragraph (e)(1) and (2) of this section to provide notice to an interest holder who is a nominee of another person with respect to an interest in the REMIC, the nominee shall furnish such notice to the actual owner or owners.

(ii) *Time for furnishing statement.* Under paragraph (e)(3)(i) of this section, the nominee shall furnish the required notice to the actual owner or owners of a REMIC interest no later than 30 days after receiving such information.

(4) *Reports to the Internal Revenue Service.* A copy of Schedule Q for each person who was a residual interest holder at any time during a REMIC's taxable year and for each quarter in which that person was a residual interest holder shall be attached to the REMIC's income tax return for that taxable year. Quarterly notice to the Internal Revenue Service is not required.

Par. 4. New §1.6049-7T is added immediately after §1.6049-6 and reads as set forth below.

§1.6049-7T Returns of information with respect to REMIC regular interests and certain other debt instruments (temporary).

(a) *Definition of interest*—(1) *In general.* For purposes of section 6049(a) in taxable years beginning after December 31, 1986, the term "interest" includes amounts includible in the gross income of any holder (other than a holder described in paragraph (c) of this section) of—

(i) A REMIC regular interest (as defined in section 860G(a)(1)), or

(ii) Any other debt instrument to which section 1272(a)(6) applies.

(2) *Amounts includible.* Amounts includible in gross income as interest under paragraph (a)(1) of this section) may consist of—

(i) Interest actually paid to the holder,

(ii) Interest accrued, but not paid, with respect to the REMIC regular interest or other debt instrument, or

(iii) Original issue discount accrued with respect to the REMIC regular interest or other debt instrument.

(b) *Requirement of reporting*—(1) *In general.* Except as provided in paragraph (c) of this section, an information return shall be made by any person described in paragraph (b)(2) of this section with respect to any amount aggregating $10 or more includible as interest under paragraph (a)(1) of this section by any other person during a calendar year.

(2) *Person required to make reports.* The persons required to make an information return under section 6049(a) and this section are—

(i) The REMIC or other issuer of a debt instrument to which section 1272(a)(6) applies, and

(ii) Any broker or middleman who holds as a nominee any REMIC regular interest or any other debt instrument to which section 1272(a)(6) applies.

(3) *Information to be reported*—(i) *Amounts other than original issue discount.* In the case of an amount includible as interest, other than original issue discount treated as interest, an information return on Form 1099 shall be made for the calendar year showing the aggregate amounts includible, the name, address, and taxpayer identification number of the person in whose income these amounts are includible, and such other information as is required by the forms.

(ii) *Original issue discount.* In the case of original issue discount, an information return on Form 1099 shall be made for each calendar year of any holder of a REMIC regular interest, or any other debt instrument to which section 1272(a)(6) applies, with respect to which there is original issue discount includible in gross income aggregating $10 or more (as determined under section 1272(a)(6) and the regulations thereunder). The information return shall show—

(A) The name, address, and taxpayer identification number of each record holder for whom an amount of original issue discount is includible in gross income,

(B) The account or serial number, or other identifying number of information, of each REMIC regular interest or other debt instrument with respect to which a return is being made,

(C) The aggregate amount of original issue discount includible in the gross income of each holder for the period during the calendar year for which the return is made,

(D) The name and address of the person filing the return, and

(E) Such other information as is required by the form.

(iii) *Cross-reference.* See §1.67-3T(f)(3)(ii) for additional information required to be included on an information return on Form 1099 with respect to certain holders of regular interest in REMICs described in §1.67-3T(a)(2)(ii).

(c) *Information returns not required.* An information return shall not be required under section 6049(a) and this section with respect to amounts includible as interest by the holder of a REMIC regular interest, or any other debt instrument to which section 1272(a)(6) applies, if the holder is—

(1) An organization exempt from taxation under section 501(a) or an individual retirement plan,

(2) The United States or a State, the District of Columbia, a possession of the United States, or a political subdivision or a wholly-owned agency or instrumentality of any one or more of the foregoing,

(3) A foreign government, a political subdivision thereof, or an international organization,

(4) A foreign central bank of issue (as defined in §1.895-1(b)(1) to be a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency), or

(5) Any trust which is described in section 4947(a)(1) (relating to certain charitable trusts).

(d) *Special rules*—(1) *Incorporation by reference.* Except as provided in paragraph (d)(2) of this section, the special rules of §1.6049-4(d) are incorporated in this section, as applicable.

(2) *Exception.* Sections 1.6049-4(d)(2) and 1.6049-5(c) shall not apply to any REMIC regular interest or any other debt instrument to which section 1272(a)(6) applies until such time as the Commissioner determines that the broader reporting of amounts includible as interest required by this section is not sufficient for an accurate accounting for those amounts by the holder of any such interest. At that time, the Commissioner may by ruling or other announcement require the submission of Form 8281 (or similar form) to the Internal Revenue Service with respect to any such interest.

(e) *Time and place for filing a return with respect to amounts includible as interest.* The returns required under this section for any calendar year with respect to amounts includible as interest to which this section applies shall be filed after September 30 of that year, but not before the payor's final payment to the payee for the year, and on or before February 28 of the following year. These returns shall be filed with the appropriate Internal Revenue Service Center, the address of which is listed in the instructions for Form 1099. For extensions of time for filing returns under this section, see §1.6081-1. For magnetic media filing requirements, see §301.6011-2.

(f) *Requirement of furnishing statement to recipient*—(1) *In general.* Every person filing a Form 1099 under section 6049(a) and this section shall furnish to the person whose identifying number is required to be shown on the form a written statement showing the information required by paragraph (f)(2) of this section.

(2) *Form of statement*—(i) *Amounts other than original issue discount.* With respect to amounts includible as interest (other than original issue discount) in the gross income of any person during a calendar year, the written statement required to be furnished under paragraph (f)(1) of this section shall show—

(A) The aggregate amounts shown on Form 1099 to be included in income by that person,

(B) The name and address of the person filing the form, and

(C) A legend, including a statement that the amount is being reported to the Internal Revenue Service, that conforms to the legend on Form 1099, Copy B, For Recipient.

(ii) *Original issue discount.* With respect to original issue discount includible in the gross income of a holder, during the calendar year, of a REMIC regular interest or other debt instrument to which section 1272(a)(6) applies, the written statement required to be furnished under paragraph (f)(1) of this section shall show—

(A) The aggregate amount of original issue discount includible in gross income by (or on behalf of) the holder for the calendar year with respect to the regular interest or other debt instrument,

(B) The information required by the paragraph (b)(3)(ii)(B) of this section,

(C) For calendar years after 1987, the daily portion of original issue discount that is allocated to each day of an accrual period as determined under section 1272(a)(6) and the regulations thereunder,

(D) For calendar years after 1987, the length of the accrual period,

(E) All other items shown on Form 1099 for the calendar year,

(F) A legend, including a statement that the information required under paragraph (f)(2)(ii)(A), (B), and (E) of this section is being reported to the Internal Revenue Service, that conforms to the legend on Form 1099, Copy B, For Recipient,

(G) For calendar years after 1987, the adjusted issue price (as defined in section 1275(a)(4)(B)(ii)) of the regular interest at the beginning of each accrual period with respect to which interest income is required to be reported on Form 1099-OID, and

(H) Information necessary to compute accrual of market discount. [Reserved].

(3) *Information with respect to REMIC assets*—(i) *95 percent asset test.* For calendar years after 1987, the statement required by paragraph (f) of this section with respect to any REMIC regular interest shall also specify for each calendar quarter during which the percentage of the REMIC's assets, computed on the basis of the average fair market value of assets held during the calendar quarter (as described in §1.860F-4T(e)(1)(ii)(A)), represented by each of the following categories:

(A) Qualifying real property loans under section 593,

(B) Assets of a domestic building and loan association (as described in section 7701(a)(19)), and

(C) Real estate assets as defined in §1.860F-4T(e)(1)(ii)(C)

is at least 95 percent, that, for each category for which the REMIC meets this test, at least 95 percent of the REMIC's assets were represented by that category for that calendar quarter. If the REMIC fails to meet the 95 percent test for any category in any calendar quarter, the percentage of the REMIC's assets represented by that category for that calendar quarter shall be provided.

(ii) *Additional information required if the 95 percent test not met.* For calendar years after 1987, if for any calendar quarter less than 95 percent of the assets of the REMIC are real estate assets (as defined in §1.860F-4T(e)(1)(ii)(C)), the REMIC shall also report for each such calendar quarter to any real estate investment trust (REIT) that holds a regular interest the following information:

(A) The percentage of the REMIC's assets described in section 856(c)(5)(A), excluding from real estate assets any property (not otherwise a real estate asset) attributable to the temporary investment of new capital, computed on the bases of the average fair market value of the assets of the REMIC during the calendar quarter (as described in §1.860F-4T(e)(1)(ii)(A)), and

(B) The percentage of the REMIc's gross income (as defined in §1.860F-4T(e)(1)(ii)(B)) described in section 856(c)(3)(A) through (F), computed as of the close of the calendar quarter. For purposes of this paragraph, the term "foreclosure property" contained in section 856(c)(3)(F) shall have the meaning specified in section 860G(a)(8).

In determining whether a REIT satisfies the limitations of section 856(c)(2), all gross income shall be deemed to be derived from a source specified in section 856(c)(2).

(4) *Cross-reference.* See §1.67-3T(f)(2)(ii) for additional information that may be separately stated on the statement required by paragraph (f) of this section with respect to certain holders of regular interest in REMICs described in §1.67-3T(a)(2)(ii).

(5) *Time for furnishing statements*—(i) *In general.* Each statement required under paragraph (f) of this section to be furnished to any person for a calendar year with respect to amounts includible as interest shall be furnished to that person after April 30 of that year and on or before January 31 of the following year, but not before the final interest payment (if any) for the calendar year.

(ii) *Nominee reporting.* Each statement required under paragraph (f) of this section to be furnished by a nominee shall be furnished to the actual owner or owners of a REMIC interest no later than 30 days after the nominee receives such information.

(6) *Special rules*—(i) *Copy of Form 1099 permissible.* The requirements of paragraph (f) of this section for the furnishing of a statement to any person, including the legend requirement of paragraph (f)(2)(i)(C) and (ii)(F) of this section, may be met by furnishing to that person—

(A) A copy of the Form 1099 filed pursuant to paragraph (b) of this section in respect of that person, plus a separate statement that contains the information described in paragraphs (f)(2)(ii)(C), (D), and (G), (f)(3), and (f)(4), if applicable, of this section, or

(B) A substitute form that contains all the information required under paragraph (f) of this section and that complies with any current revenue procedure concerning the reproduction of paper substitutes of Forms 1099 and the furnishing of substitute statements to forms recipients.

(ii) *Statement furnished by mail.* A statement mailed to the last known address of any person shall be considered to be furnished to that person within the meaning of this section.

(g) *Information required to be set forth on face of debt instrument.* In the case of any REMIC regular interest, or any other debt instrument to which section 1272(a)(6) applies, that is issued after April 8, 1988, and that has original issue discount, the issuer shall set forth on the face of the regular interest or other debt instrument—

(1) The amount of the original issue discount,

(2) The issue date,

(3) The rate at which interest is payable (if any) as of the issue date, and

(4) The yield to maturity, including a statement as to the assumption made under section 1272(a)(6)(B)(iii), the method used to determine yield where there is a short accrual period, and the amount of the original issue discount allocable to the short accrual period.

In cases where it is not possible to set forth the information required by this paragraph (g) on the face of the regular interest or other debt instrument by the issue date, the issuer shall deliver to the holder a sticker containing this information within 10 days after the issue date. For rules relating to the penalty imposed for failure to show the information required by this paragraph (g) on the regular interest or other debt instrument, see section 6706(a) and the regulations thereunder.

OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

PART 602

Par. 5. The authority citation for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 6. Section 602.101(c) is amended by adding to the table in the appropriate place—

"§1.67-3T .... 1545-0118",
"§1.860D-1T.......... 1545-0118",
"§1.860F-4T ...... 1545-0118", and
"§1.6049-7T .... 1545-0118".

There is a need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue this Treasury decision with notice and public procedure under subsection (b) or section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved February 23, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 4, 1988, 3:03 p.m., and published in the issue of the Federal Register for March 9, 1988, 53 F.R. 7504)

Section 88.—Certain Amounts with Respect to Nuclear Decommissioning Costs

26 CFR 1.88-1: Nuclear decommissioning costs.

T.D. 8184

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; SUBCHAPTER H—INTERNAL REVENUE PRACTICE, PART 602.—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Special Rules Relating to Nuclear Decommissioning Costs

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the Federal income tax treatment of nuclear decommissioning costs. Changes to the applicable law were made by the Tax Reform Act of 1984 and the Tax Reform Act of 1986. The regulations affect all taxpayers that include nuclear decommissioning costs in cost of service for ratemaking purposes.

DATES: The regulations are effective on July 18, 1984, and apply with respect to taxable years ending on or after such date.

SUPPLEMENTARY INFORMATION

BACKGROUND

Sections 88 and 468A of the Internal Revenue Code of 1986 (the Code) were added by subsections (f) and (c), respectively, of section 91 of the Tax Reform Act of 1984 (Pub. L. 98-369, 98 Stat. 598). In addition, sections 88 and 468A were amended by section 1807(a)(4) of the Tax Reform Act of 1986 (Pub. L. 99-514; 100 Stat. 2812). On July 10, 1986, the FEDERAL REGISTER published amendments (T.D. 8094; 51 FR 25033) to the Income Tax Regulations (26 CFR Part 1) and the Table of OMB Control Numbers (26 CFR Part 602) to provide temporary regulations under sections 88 and 468A. The same issue of the FEDERAL REGISTER also published proposed amendments (51 FR 25070) to the Income Tax Regulations and the Table of OMB Control Numbers based on those temporary regulations. This document supersedes the temporary regulations under sections 88 and 468A and adopts final regulations based on the notice of proposed rulemaking published on July 10, 1986.

Before adopting the final regulations, the Internal Revenue Service solicited comments and held a public hearing on the proposed amendments. Fourteen written comments responding to the notice of proposed rulemaking were received. In addition, three persons provided oral comments at the public hearing held on October 22, 1986. After consideration of all comments received, the proposed amendments are adopted as revised by this Treasury decision.

PUBLIC COMMENTS

I. *Inclusion of Decommissioning Costs in Gross Income (§1.88-1).*

One commentator requested guidance with respect to the treatment of amounts collected for decommissioning by municipalities that do not own or operate a nuclear power plant, but are contractually obligated to pay a percentage of the decommissioning costs incurred by the owner/operator (or lessee/operator). Several municipalities have been collecting decommissioning costs from their customers and have been contributing the amounts collected to a fund maintained by the municipality. The commentator contends that amounts collected for decommissioning by municipalities should not be included in the gross income of the owner/operator (or lessee/operator) because the municipality is liable for a fixed percentage of the decommissioning costs incurred by the owner/operator (or lessee/operator). In addition, the commentator contends that such amounts should not be currently taxed to the owner/operator (or lessee/operator) because section 88 applies only to traditional cost-of-service ratemaking proceedings and not to privately-negotiated life-of-unit contracts that are filed with the Federal Energy Regulatory Commission.

The Internal Revenue Service believes that the amount of decommissioning costs included in the cost of service of a taxpayer that holds a qualifying interest in a nuclear power plant for any taxable year includes all decommissioning costs that consumers are liable to pay by reason of electric energy furnished by the taxpayer during such taxable year even if such costs are not payable to (or on behalf of) the taxpayer until decommissioning occurs.

The owner/operator (or lessee/operator) of a nuclear power plant should not be able to avoid the current inclusion of such amounts in income by entering into a contract which provides that another person is liable for a percentage of the decommissioning costs to be incurred by the owner/operator (or lessee/operator). Otherwise, the taxpayer could achieve the equivalent of a section 468A deduction without complying with the rules that prohibit self-dealing and restrict the investments of a nuclear decommissioning fund.

Therefore, the final regulations provide that decommissioning costs directly or indirectly charged to the customers of a taxpayer include all decommissioning costs that consumers are liable to pay by reason of electric energy furnished by the taxpayer during the taxable year, whether payable to the taxpayer, a trust, State government, or other entity (other than a holder of a leasehold interest in any portion of the nuclear power plant if such interest is a qualifying interest within the meaning of paragraph (b)(2)(ii) of §1.468A-1), and even though the taxpayer may not control the investment or current expenditure of the amount and the amount may not be paid to the taxpayer at the time decommissioning costs are incurred. In addition, the final regulations contain an example that illustrates the treatment of amounts collected for decommissioning by a municipality that does not possess a qualifying interest in a nuclear power plant but is contractually obligated to pay a percentage of the decommissioning costs incurred by the owner/operator (or lessee/operator).

II. *Nuclear Decommissioning Costs; Definitions and General Rules (§1.468A-1).*

Several commentators objected to the definition of the term "eligible taxpayer." Most of these commentators believe that the term should include the lessee of a nuclear power plant especially if the lessee is primarily liable for decommissioning the nuclear power plant. Another commentator believes that the owner of stock in a non-profit corporation which owns an experimental nuclear facility should be allowed to make deductible contributions to a nuclear decommissioning fund established with respect to such experimental facility. The temporary regulations do not allow the owner of the stock to establish a nuclear decommissioning fund because (1) the experimental facility is not used predominantly in the trade or business of the furnishing or sale of electric energy and (2) the facility is owned directly by the non-profit corporation and not by the owner of stock in the non-profit corporation.

The final regulations permit the lessee of a nuclear power plant to establish a nuclear decommissioning fund with respect to the leasehold interest if (1) the lessee is subject to the jurisdiction of a public utility commission with respect to the nuclear power plant, (2) the lessee is primarily liable under Federal or State law for decommissioning the portion of the nuclear power plant to which the leasehold interest relates and (3) not other person establishes a nuclear decommissioning fund with respect to the portion of the nuclear power plant to which the leasehold interest relates.

In addition, the final regulations provide that a person possessing a qualifying interest in an experimental nuclear facility may establish a nuclear decommissioning fund with respect to the facility if (1) such person is engaged in the trade or business of the furnishing or sale of electric energy, (2) the rates charged for electric energy furnished or sold by such person are established or approved by a public utility commission, and (3) the cost of decommissioning the facility is included in the cost of service of such person. In addition, a person that satisfies these conditions and owns stock in a corporation that owns an experimental nuclear facility may establish a nuclear decommissioning fund with respect to the facility if the corporation that directly owns the facility is not engaged in the trade or business of the furnishing or sale of electric energy.

Another commentator suggested that the members of an affiliated group of corporations that join in the filing of a consolidated return (a "consolidated group") should be treated as a single taxpayer for all purposes under the regulations. The commentator believes that (1) a single nuclear decommissioning fund should be allowed with respect to a nuclear power plant that is owned by several corporations that are members of a consolidated group and (2) the consolidated group should be allowed to file a single request for a schedule of ruling amounts.

Although the final regulations do not treat the members of a consolidated group as a single taxpayer for purposes of section 468A, changes have been made to reduce the administrative burden imposed on members of a consolidated group. First, the nuclear decommissioning fund qualification requirements have been modified to permit a single trust for two or more nuclear decommissioning funds. In addition, if certain conditions are satisfied (see Part VI below), the assets of two or more nuclear decommissioning funds can be commingled by the trustee for the purpose of making permissible investments. Finally, the regulations provide that the common parent of a consolidated group may request a schedule of ruling amounts for each member of the group that possesses a qualifying interest in the same nuclear power plant by filing a single submission with the Internal Revenue Service.

III. *Treatment of Electing Taxpayer (§1.468A-2).*

Two commentators believe that post-ratemaking proceedings of a public utility commission should be considered in determining the cost of service amount. A third commentator suggested that utilities should be permitted to establish the cost of service amount for periods prior to the issuance of the regulations based on their own books and records (rather than the records of a ratemaking proceeding). The Internal Revenue Service believes that it is inappropriate to adopt a rule of general application that considers post-ratemaking proceedings in determining the cost of service amount. The final regulations provide, however, that the cost of service amount for any taxable year that begins before January 1, 1987, shall include decommissioning costs that can be accurately determined from information contained in the regulated books of account or other written records of the taxpayer.

Several commentators believe that amounts remaining in the nuclear decommissioning fund upon substantial completion of decommissioning, should not be included in the gross income of the electing taxpayer if the electing taxpayer is not permitted to retain such amounts. The temporary regulations provide an exclusion for amounts that an electing taxpayer is required to refund to customers within one year after the substantial completion of decommissioning. The commentators suggest that no amount should be included in gross income even if the public utility commission requires the excess to be refunded over a longer period or requires the excess to be paid to an energy conservation program or other similar program.

The Internal Revenue Service has reconsidered the "refund" exception to the general rule that amounts distributed from a nuclear decommissioning fund must be included in gross income for the taxable year in which the distribution occurs and has determined that the exception is inappropriate. In order to properly reflect the time value of money, amounts remaining in a nuclear decommissioning fund upon substantial completion of decommissioning are includible in the gross income of the electing taxpayer for the taxable year that includes the date of substantial completion of decommissioning and amounts refunded to ratepayers are deductible for the taxable year in which section 461(h) is satisfied.

IV. *Ruling Amount (§1.468A-3).*

One commentator believes that the periods used to determine the qualifying percentage (i.e., the estimated period for which a nuclear decommissioning fund is to be in effect and the estimated useful life of a nuclear power plant) should be based on the length of the operating license granted by the Nuclear Regulatory Commission. The commentator contends that the definition of qualifying percentage contained in the temporary regulations (which is generally based on the ratemaking assumptions used by the public utility commission during the first ratemaking proceeding in which the nuclear power plant was included in rate base) is inequitable and inconsistent with congressional intent.

The final regulations provide that in the case of a nuclear power plant that began commercial operations before July 18, 1984, a taxpayer may elect to compute the qualifying percentage by assuming that the estimated period for which the nuclear decommissioning fund is to be in effect and the estimated useful life of the nuclear power plant end on the last day of the taxable year that includes the expiration date of the Nuclear Regulatory Commission operating license as in effect on July 18, 1984, but without regard to extensions or amendments thereto.

Several commentators believe that the Service should provide a ruling amount for a taxable year even if the request for a schedule of ruling amounts that includes a proposed ruling amount for such taxable year is filed after the 180th day of the taxable year. The commentators contend that it is unfair for a taxpayer to be denied an initial or revised ruling amount for a taxable year if a rate order permitting recovery of decommissioning costs is received after the 180th day of the taxable year.

The final regulations provide that the Internal Revenue Service shall not provide or revise a ruling amount applicable to any taxable year in response to a request for a schedule of ruling amounts that is filed after the 15th day of the third calendar month following the close of the taxable year. In addition, the final regulations permit taxpayers that have filed a timely request for an initial or revised ruling amount for a taxable year to make deductible contributions to a nuclear decommissioning fund prior to the receipt of the initial or revised ruling amount for such taxable year. The amount of the contribution may not exceed the ruling amount proposed by the taxpayer for such taxable year. If the ruling amount provided by the Internal Revenue Service for such taxable year is less than amount proposed by the taxpayer and an excess contribution results, the amount of the excess contribution must be withdrawn by the taxpayer.

V. *Treatment of Nuclear Decommissioning Fund (§1.468A-4).*

One commentator requested clarification on whether gain or loss is recognized by a nuclear decommissioning fund that exchanges a municipal bond for another municipal bond if there are no material differences in the terms of the bonds. Revenue Ruling 56-435, 1956-2 C.B. 506, and Revenue Ruling 81-169, 1981-1 C.B. 429, provide that the exchange of a municipal bond for another municipal bond is not a taxable transaction if there are no material differences in the terms of the bonds. Nothing in the final regulations limits the applicability of these revenue rulings. Accordingly, the rulings apply to municipal bonds exchanged by nuclear decommissioning funds.

VI. *Nuclear Decommissioning Fund Qualification Requirements, Etc. (§1.468A-5).*

Several commentators requested clarifications and changes with respect to the number of nuclear decommissioning funds that are required under the temporary regulations. Some of these commentators believe that a single nuclear decommissioning fund should be allowed for two or more nuclear power plants or for two or more electing taxpayers. Other commentators believe that two or more nuclear decommissioning funds should be allowed for a single nuclear power plant especially if two or more public utility commissions that establish or approve rates for electric energy generated by the nuclear power plant require separate funds. Finally, two commentators requested that the regulations permit the assets of two or more funds to be invested on a pooled or commingled basis.

The final regulations require a separate nuclear decommissioning fund for each electing taxpayer and for each nuclear power plant with respect to which the electing taxpayer possesses a qualifying interest. The final regulations provide, however, that two or more nuclear decommissioning funds can be established and maintained pursuant to a single trust agreement. In addition, the assets of two or more funds can be pooled by the trustee for the purpose of making permissible investments if (1) the trustee of each nuclear decommissioning fund separately accounts for the contributions, earnings, expenses and distributions of such fund, (2) the earnings and expenses are reasonably apportioned among the pooled funds, and (3) the books and records of such funds enable the Internal Revenue Service to verify that the requirements of section 468A and the regulations are satisfied.

The final regulations also provide that an electing taxpayer can maintain only one nuclear decommissioning fund for each nuclear power plant with respect to which the taxpayer elects the application of section 468A. If a nuclear power plant is subject to the ratemaking jurisdiction of two or more public utility commissions and any such public utility commission requires a separate fund to be maintained for the benefit of ratepayers whose rates are established or approved by the public utility commission, the separate funds maintained for the plant shall be considered a single nuclear decommissioning fund for purposes of section 468A and the regulations. Thus, for example, the Internal Revenue Service shall issue one schedule of ruling amounts with respect to the nuclear power plant, the nuclear decommissioning fund must file a single income tax return, and, if the Internal Revenue Service disqualifies the nuclear decommissioning fund, the assets of each separate fund are treated as distributed on the date of disqualification.

Several commentators believe that electing taxpayers should be allowed to contribute permissible investments to a nuclear decommissioning fund especially if such investments were made before the issuance of the regulations. In addition, two commentators believe that an electing taxpayer that purchased permissible investments before the issuance of the regulations should be allowed to contribute such investments to a nuclear decommissioning fund without the recognition of gain or loss upon the transfer.

Unlike section 192(c)(4) (relating to black lung benefit trusts) and section 468B(d)(1) (relating to designated settlement funds), section 468A does not authorize the contribution of permissible investments or other property to a nuclear decommissioning fund. Nevertheless, the final regulations provide that an electing taxpayer may contribute permissible investments to a nuclear decommissioning fund for a taxable year that ends on or after July 18, 1984, and begins before the date of publication of the final regulations if the investments were acquired by the taxpayer after July 18, 1984 and before the date of publication of the final regulations. Under the final regulations, the transfer of the investments to the nuclear decommissioning fund shall be considered a sale or exchange for purposes of section 1001. Except as provided in this transitional rule, a nuclear decommissioning fund is not allowed to accept any contributions other than cash contributions that are deductible under section 468A.

One commentator asked whether the assets of a nuclear decommissioning fund can be invested in an annuity contract or mutual fund if the assets of the annuity contract or mutual fund are invested solely in public debt securities of the United States, obligations of a State or local government, or time or demand deposits. The final regulations provide that the assets of a nuclear decommissioning fund must be invested directly in public debt securities of the United States, obligations of a State or local government, or time or demand deposits. Thus, annuity contracts and mutual funds are not permissible investments of a nuclear decommissioning fund.

Another commentator requested clarification with respect to the definition of public debt securities of the United States. The regulations provide that the term public debt securities of the United States means obligations that are taken into consideration for purposes of the public debt limit. The Bureau of Public Debt has informed the Internal Revenue Service that the only outstanding obligations that are taken into account for purposes of the public debt limit and that are generally available for purchase are Treasury bills, Treasury notes, Treasury bonds, and savings bonds.

A few commentators objected to the definition of substantial completion of decommissioning contained in the temporary regulations. Under that definition, substantial completion of decommissioning occurs at the time the maximum acceptable radioactivity levels mandated by the Nuclear Regulatory Commission with respect to a decommissioned nuclear power plant are satisfied. One commentator believes that the definition of substantial completion of decommissioning should be modified to accommodate special or individual circumstances. A second commentator recommends that substantial completion of decommissioning occur when (1) all decommissioning activities (including physical security and radiation monitoring) are completed or (2) the taxpayer or the public utility commission determines that decommissioning activities have been completed. A third commentator believes that a nuclear decommissioning fund should not be considered terminated, even upon substantial completion of decommissioning, if the applicable public utility commission reasonably requires a nuclear decommissioning fund to be maintained.

The final regulations adopt the definition of substantial completion of decommissioning that was contained in the temporary regulations with a minor modification. If a significant portion of the total estimated decommissioning costs with respect to a nuclear power plant are not incurred as of the date that the maximum acceptable radioactivity levels mandated by the Nuclear Regulatory Commission with respect to a decommissioned nuclear power plant are satisfied, the taxpayer may request, and the Internal Revenue Service shall issue, a ruling that designates the date on which substantial completion of decommissioning occurs. The date designated in the ruling shall not be later than the last day of the third taxable year after the taxable year in which the maximum acceptable radioactivity levels mandated by the Nuclear Regulatory Commission with respect to a decommissioned nuclear power plant are satisfied.

VII. *Disposition of an Interest in a Nuclear Power Plant (§1.468A-6).*

The temporary regulations treated a disposition of an interest in a nuclear power plant as a deemed distribution by the nuclear decommissioning fund that relates to the transferred interest. As a result of this treatment, the amount of the deemed distribution is included in gross income by the transferor of the interest and the nuclear decommissioning fund recognizes gain or loss on the assets involved in the deemed distribution.

The Internal Revenue Service received several comments criticizing this rule and is reconsidering the rule in light of these comments. Accordingly, the final regulations do not include rules relating to the disposition of an interest in a nuclear power plant. Proposed regulations on this subject will be published in the future.

VIII. *Manner of and Time for Making Election (§1.468A-7).*

Two commentators requested guidance on how the members of a consolidated group are to elect the application of section 468A. The final regulations require the common parent of the consolidated group to make a separate election on behalf of each member of the group that deducts payments under section 468A for a taxable year. The election is made on behalf of a member by providing the name, address and taxpayer identification number of the member, together with all other required information, on an election statement that is attached to the consolidated return for the taxable year.

IX. *Effective Date and Transitional Rules (§1.468A-8).*

A number of comments on the effective date and transitional rules are discussed in the context of the substantive rules to which the comments relate. In addition, one commentator believes that the addition to tax for the failure to pay estimated taxes for a taxable year beginning before January 1, 1987, should not apply if a deduction under section 468A for such taxable year would have eliminated the estimated tax. The final regulations adopt this suggestion.

X. *Miscellaneous comments.*

The Internal Revenue Service received a number of comments in addition to those summarized above. Some of the suggestions contained in the comments have been adopted in the final regulations. Other suggested changes were rejected primarily because the suggested changes were inconsistent with section 468A as amended by section 1807(a)(4) of the Tax Reform Act of 1986.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this rule is not a major rule as defined in Executive Order 12291 and therefore a Regulatory Impact Analysis is not required. Although a notice of proposed rulemaking soliciting public comments was issued, the Internal Revenue Service concluded when the notice was issued that the regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The collection of information requirements contained in this regulation have been approved by the Office of Management and Budget (OMB) under section 3507 of the Paperwork Reduction Act.

LIST OF SUBJECTS
26 CFR 1.61-1 through 1.281-4
Income taxes, Taxable income,
Deductions, Exemptions.
26 CFR 1.441-1 through 1.483-2
Income taxes, Accounting, Deferred
compensation plans
26 CFR 602
Reporting and recordkeeping
requirements.

Adoption of amendments to the regulations

For the reasons set out in the preamble, Subchapter A, Part 1, and Subchapter H, Part 602, of Title 26, Chapter I of the Code of Federal Regulations are amended as set forth below:

INCOME TAX REGULATIONS
(26 CFR Part 1)

Paragraph 1. The authority for Part 1 is amended by removing the following citation:

Section 1.468A-5T also issued under 26 U.S.C. 468A(e)(5).

Par. 2. 26 CFR Part 1 is amended by removing §1.88-1T and §1.468A-1T through §1.468-8T.

Par. 3. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. *** Section 1.468A-5 also issued under 26 U.S.C. 468A(e)(5).

Par. 4. The following new section is added immediately after §1.85-1 to read as follows:

§1.88-1 Nuclear decommissioning costs.

(a) *In general.* Section 88 provides that the amount of nuclear decommissioning costs directly or indirectly charged to the customers of a taxpayer that is engaged in the furnishing or sale of electric energy generated by a nuclear power plant must be included in the gross income of such taxpayer in the same manner as amounts charged for electric energy. For this purpose, decommissioning costs directly or indirectly charged to the customers of a taxpayer include all decommissioning costs that consumers are liable to pay by reason of electric energy furnished by the taxpayer during the taxable year, whether payable to the taxpayer, a trust, State government, or other entity, and even though the taxpayer may not control the investment or current expenditure of the amount and the amount may not be paid to the taxpayer at the time decommissioning costs are incurred. However, decommissioning costs payable to a taxpayer holding a qualified leasehold interest (as described in paragraph (b)(2)(ii) of §1.468A-1) are included in the gross income of such taxpayer, and not in the gross income of the lessor.

(b) *Examples.* The following examples illustrate the application of the principles of paragraph (a) of this section:

Example (1). X corporation, an accrual method taxpayer engaged in the sale of electric energy generated by a nuclear power plant owned by X, is authorized by the public utility commission of State A to collect nuclear decommissioning costs from ratepayers residing in State A. With respect to the sale of electric energy, X includes in income amounts that have been billed to customers as well as estimated unbilled amounts that relate to energy provided by X after the previous billing but before the end of the taxable year ("accrued unbilled amounts"). The decommissioning costs are included in the monthly bills provided by X to its ratepayers and the entire amount billed is remitted directly to X. Under paragraph (a) of this section, the decommissioning costs must be included in the gross income of X in the same manner as amounts charged for electric energy (*i.e.*, by including in income decommissioning costs that relate to amounts billed as well as decommissioning costs that relate to accrued unbilled amounts). The same rule would apply if the decommissioning costs charged to ratepayers were separately billed and the amounts billed were remitted to State A to be held in trust for the purpose of decommissioning the nuclear power plant owned by X. In that case, X must include in gross income decommissioning costs that relate to amounts billed as well as decommissioning costs that relate to accrued unbilled amounts.

Example (2). Assume the same facts as in Example (1), except that X and M, a municipality located in State A, have entered into a life-of-unit contract pursuant to which (i) M is entitled to 20 percent of the electric energy generated by the nuclear power plant owned by X, and (ii) M is obligated to pay 20 percent of the plant operating costs, including decommissioning costs, incurred by X. Under paragraph (a) of this section, the decommissioning costs that relate to electric energy consumed or distributed by M during any taxable year must be included in the gross income of X for such taxable year. The result contained in this example would be the same if M was a State or an agency or instrumentality of a State or a political subdivision thereof.

(c) *Cross reference.* For special rules relating to the deduction for amounts paid to a nuclear decommissioning fund, see §1.468A-1 through §1.468A-8.

(d) *Effective date.* (1) Section 88 and this section apply to nuclear decommissioning costs directly or indirectly charged to the customers of a taxpayer on or after July 18, 1984, and with respect to taxable years ending on or after such date.

(2) If the amount of nuclear decommissioning costs directly or indirectly charged to the customers of a taxpayer before July 18, 1984, was includible in gross income in a different manner than amounts charged for electric energy, such amount must be included in gross income for the taxable year in which includible in gross income under the method of accounting of the taxpayer that was in effect when such amount was charged to customers.

Par. 5. The following new sections are added in the appropriate places:

§1.468A-0 Nuclear decommissioning costs; table of contents.

This section lists the paragraphs contained in §§1.468A-1 through 1.468A-8.

§1.468A-1 Nuclear decommissioning costs; general rules.

(a) Introduction.

(b) Definitions.

(c) Special rules applicable to certain experimental nuclear facilities.

§1.468A-2 Treatment of electing taxpayer.

(a) In general.
(b) Limitation on payments to a nuclear decommissioning fund.
(1) In general.
(2) Cost of service amount.
(c) Deemed payment rules.
(d) Treatment of distributions.
(1) In general.
(2) Exceptions to inclusion in gross income.
(i) Payment of administrative costs and incidental expenses.
(ii) Withdrawals of excess contributions.
(iii) Actual distributions of amounts included in gross income as deemed distributions.
(e) Deduction when economic performance occurs.
(f) Effect of interim rate orders and retroactive adjustments to such orders.
(1) In general.
(2) Special rule permitting withdrawal of excess contribution that results from retroactive adjustment to interim rate order.
(3) Revised schedule of ruling amounts.
(4) Example.

§1.468A-3 Ruling amount.
(a) In general.
(b) Level funding limitation.
(c) Funding period.
(1) General rule.
(2) Examples.
(d) Decommissioning costs allocable to a fund.
(1) General rule.
(2) Total estimated cost of decommissioning.
(3) Taxpayer's share.
(4) Qualifying percentage.
(e) Determination of estimated dates.
(f) Special rules in the case of rates established or approved by two or more public utility commissions.
(g) Requirement of determination by public utility commission of decommissioning costs to be included in cost of service.
(h) Manner of requesting schedule of ruling amounts.
(1) In general.
(2) Information required.
(3) Administrative procedures.
(i) Review and revision of schedule of ruling amounts.
(1) Mandatory review.
(2) Elective review.
(3) Determination of revised schedule of ruling amounts.
(j) Special rule permitting payments to a nuclear decommissioning fund before receipt of an initial or revised ruling amount applicable to a taxable year.

§1.468A-4 Treatment of nuclear decommissioning fund.
(a) In general.
(b) Modified gross income.
(c) Special rules.
(1) Period for computation of modified gross income.
(2) Gain or loss upon distribution of property by a fund.
(3) Denial of credits against tax.
(4) Other corporate taxes inapplicable.
(d) Treatment as corporation for purposes of subtitle F.

§1.468A-5 Nuclear decommissioning fund—miscellaneous provisions.
(a) Qualification requirements.
(1) In general.
(2) Limitation on contributions.
(3) Limitation on use of fund.
(i) In general.
(ii) Terms defined.
(b) Prohibitions against self-dealing.
(1) In general.
(2) Self-dealing defined.
(3) Disqualified person defined.
(c) Disqualification of nuclear decommissioning fund.
(1) In general.
(2) Exception to disqualification.
(i) In general.
(ii) Excess contribution defined.
(iii) Taxation of income attributable to an excess contribution.
(3) Effect of disqualification.
(d) Termination of nuclear decommissioning fund upon substantial completion of decommissioning.
(1) In general.
(2) Substantial completion of decommissioning defined.

§1.468A-6 Disposition of an interest in a nuclear power plant. [Reserved]

§1.468A-7 Manner of and time for making election.
(a) In general.
(b) Required information.

§1.468A-8 Effective date and transitional rules.
(a) Effective date.
(1) In general.
(2) Cut-off method applicable to electing taxpayers.
(b) Transitional rules.
(1) Time for filing request for schedule of ruling amounts.
(2) Manner of and time for making contributions to a nuclear decommissioning fund.
(3) Manner of and time for making election.
(4) Determination of cost of service limitation.
(5) Assumptions and determinations to be used in determining ruling amounts.
(6) Exception to level funding limitation.
(7) Determination of qualifying percentage.
(8) Limitation on payments to a nuclear decommissioning fund.
(9) Denial of interest on overpayment.
(10) Determination of addition to tax for failure to pay estimated tax.

§1.468A-1 Nuclear decommissioning costs; general rules.

(a) *Introduction*. Section 468A provides an elective method for taking into account nuclear decommissioning costs for Federal income tax purposes. In general, an eligible taxpayer that elects the application of section 468A pursuant to the rules contained in §1.468A-7 is allowed a deduction (as determined under §1.468A-2) for the taxable year in which the taxpayer makes a cash payment to a nuclear decommissioning fund. Taxpayers using an accrual method of accounting that do not elect the application of section 468A are not allowed a deduction for nuclear decommissioning costs prior to the taxable year in which economic performance occurs with respect to such costs (see section 461(h)).

(b) *Definitions.* The following terms are defined for purposes of §§1.468A-1 through 1.468A-8:

(1) The term "eligible taxpayer" means any taxpayer that possesses a qualifying interest in a nuclear power plant (including a nuclear power plant that is under construction).

(2) The term "qualifying interest" means—

(i) A direct ownership interest; and

(ii) A leasehold interest in any portion of a nuclear power plant if—

(A) The holder of the leasehold interest is subject to the jurisdiction of a public utility commission with respect to such portion of the nuclear power plant;

(B) The holder of the leasehold interest is primarily liable under Federal or State law for decommissioning such portion of the nuclear power plant; and

(C) No other person establishes a nuclear decommissioning fund with respect to such portion of the nuclear power plant.

A direct ownership interest includes an interest held as a tenant in common or joint tenant, but does not include stock in a corporation that owns a nuclear power plant or an interest in a partnership that owns a nuclear power plant. Thus, in the case of a partnership that owns a nuclear power plant, the election under section 468A must be made by the partnership and not by the partners. In the case of an unincorporated organization described in §1.761-2(a)(3) that elects under section 761(a) to be excluded from the application of subchapter K, each taxpayer that is a co-owner of the nuclear power plant is eligible to make a separate election under section 468A.

(3) The term "nuclear decommissioning fund" means a fund that satisfies the requirements of §1.468A-5.

(4) The term "nuclear power plant" means any nuclear power reactor that is used predominantly in the trade or business of the furnishing or sale of electric energy, if the rates for such furnishing or sale, as the case may be, have been established or approved by a public utility commission. Each unit (*i.e.*, nuclear reactor) located on a multi-unit site is a separate nuclear power plant.

(5) The term "nuclear decommissioning costs" or "decommissioning costs" means all otherwise deductible expenses to be incurred in connection with the entombment, decontamination, dismantlement, removal and disposal of the structures, systems and components of a nuclear power plant that has permanently ceased the production of electric energy. Such term includes all otherwise deductible expenses to be incurred in connection with the preparation for decommissioning, such as engineering and other planning expenses, and all otherwise deductible expenses to be incurred with respect to the plant after the actual decommissioning occurs, such as physical security and radiation mointoring expenses. Such term does not include otherwise deductible expenses to be incurred in connection with the disposal of spent nuclear fuel under the Nuclear Waste Policy Act of 1982 (Pub. L. 97-425). An expense is otherwise deductible for purposes of this paragraph (b)(5) if it would be deductible under chapter 1 of the Internal Revenue Code without regard to section 280B.

(6) The term "public utility commission" means any State or political subdivision thereof, any agency, instrumentality or judicial body of the United States, or any judicial body, commission or other similar body of the District of Columbia or of any State or any political subdivision thereof that establishes or approves rates for the furnishing or sale of electric energy.

(7) The term "ratemaking proceeding" means any proceeding before a public utility commission in which rates for the furnishing or sale of electric energy are established or approved. Such term includes a generic proceeding that applies to two or more taxpayers that are subject to the jurisdiction of a single public utility commission.

(c) *Special rules applicable to certain experimental nuclear facilities.* (1) The owner of a qualifying interest in an experimental nuclear facility possesses a qualifying interest in a nuclear power plant for purposes of paragraph (b) of this section if—

(i) Such person is engaged in the trade or business of the furnishing or sale of electric energy;

(ii) The rates charged for electric energy furnished or sold by such person are established or approved by a public utility commission; and

(iii) The cost of decommissioning the facility is included in the cost of service of such person.

(2) An owner of stock in a corporation that owns an experimental nuclear facility possesses a qualifying interest in a nuclear power plant for purposes of paragraph (b)(1) of this section if—

(i) Such stockholder satisfies the conditions of paragraph (c)(1)(i) through (iii) of this section; and

(ii) The corporation that directly owns the facility is not engaged in the trade or business of the furnishing or sale of electric energy.

(3) For purposes of this paragraph (c), an experimental nuclear facility is a nuclear power reactor that is used predominantly for the purpose of conducting experimentation and research.

§1.468A-2 Treatment of electing taxpayer.

(a) *In general.* An eligible taxpayer that elects the application of section 468A pursuant to the rules contained in §1.468A-7 (an "electing taxpayer") is allowed a deduction for the taxable year in which the taxpayer makes a cash payment (or is deemed to make a cash payment as provided in paragraph (c) of this section) to a nuclear decommissioning fund. The amount of the deduction for any taxable year equals the total amount of cash payments made (or deemed made) by the electing taxpayer to a nuclear decommissioning fund (or nuclear decommissioning funds) during such taxable year. A payment may not be made (or deemed made) to a nuclear decommissioning fund before the first taxable year in which all of the following conditions are satisfied:

(1) The construction of the nuclear power plant to which the nuclear decommissioning fund relates has commenced.

(2) Nuclear decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates are included in the taxpayer's cost of service for ratemaking purposes (see paragraph (b) of this section).

(3) A ruling amount is applicable to the nuclear decommissioning fund (see §1.468A-3).

(b) *Limitation on payments to a nuclear decommissioning fund*—(1) *In general.* For purposes of paragraph (a) of this section, the maximum amount of cash payments made (or deemed made) to a nuclear decommissioning fund during any taxable year shall not exceed the lesser of—

(i) The cost of service amount applicable to the nuclear decommissioning fund for such taxable year (as defined in paragraph (b)(2) of this section); or

(ii) The ruling amount applicable to the nuclear decommissioning fund for such taxable year (as determined under §1.468A-3).

If the amount of cash payments made (or deemed made) to a nuclear decommissioning fund during any taxable year exceeds the limitation of this paragraph (b)(1), the excess is not deductible by the electing taxpayer. In addition, see paragraph (c) of §1.468A-5 for rules which provide that the Internal Revenue Service may disqualify a nuclear decommissioning fund if the amount of cash payments made (or deemed made) to a nuclear decommissioning fund during any taxable year exceeds the limitation of this paragraph (b)(1).

(2) *Cost of service amount.* (i) For purposes of section 468A and the regulations thereunder, the "cost of service amount applicable to a nuclear decommissioning fund for a taxable year" is the amount of decommissioning costs included in the electing taxpayer's cost of service for ratemaking purposes for such taxable year. Decommissioning costs are included in cost of service for a taxable year only to the extent such costs are directly or indirectly charged to customers of the taxpayer by reason of electric energy consumed during such taxable year or are otherwise required to be included in the taxpayer's income under section 88 and the regulations thereunder.

(ii) Except as otherwise provided in paragraph (b)(4)(i) of §1.468A-8 (relating to a special transitional rule), decommissioning costs shall generally not be considered included in cost of service for purposes of this section unless—

(A) The order or opinion of the applicable public utility commission identifies the amount of decommissioning costs that is included in cost of service for ratemaking purposes; or

(B) The written records of the ratemaking proceeding clearly and unambiguously indicate the amount of decommissioning costs that is included in cost of service for ratemaking purposes.

(iii) Except as otherwise provided in paragraph (f)(2) of this section (relating to a special rule that applies to certain retroactive adjustments to interim rate orders), orders or opinions of a public utility commission that are issued after the close of any taxable year shall not be considered in determining the amount of decommissioning costs included in cost of service for such taxable year.

(iv) If a taxpayer possesses a qualifying interest in two or more nuclear power plants that are the subject of a single ratemaking proceeding, the amount of decommissioning costs included in cost of service pursuant to such ratemaking proceeding must be allocated among such nuclear power plants. Such allocation must be reasonable and consistent, and must take into account the assumptions and determinations, if any, used by the public utility commission in establishing or approving the amount of decommissioning costs included in cost of service.

(c) *Deemed payment rules.* (1) The amount of any cash payment made by an electing taxpayer to a nuclear decommissioning fund on or before the 15th day of the third calendar month after the close of any taxable year (the "deemed payment deadline date") shall be deemed made during such taxable year if the electing taxpayer irrevocably designates the amount as relating to such taxable year on its timely filed Federal income tax return for such taxable year (see paragraph (b)(4)(iv) of §1.468A-7 for rules relating to such designation).

(2) The amount of any cash payment made by a customer of an electing taxpayer to a nuclear decommissioning fund of such electing taxpayer shall be deemed made by the electing taxpayer if the amount is included in the gross income of the electing taxpayer in the manner prescribed by section 88 and §1.88-1.

(d) *Treatment of distributions*—(1) *In general.* Except as otherwise provided in paragraph (d)(2) of this section, the amount of any actual or deemed distribution from a nuclear decommissioning fund shall be included in the gross income of the electing taxpayer for the taxable year in which the distribution occurs. The amount of any distribution of property equals the fair market value of the property on the date of the distribution. A distribution from a nuclear decommissioning fund shall include an expenditure from the fund or the use of the fund's assets—

(i) To satisfy, in whole or in part, the liability of the electing taxpayer for decommissioning costs of the nuclear power plant to which the fund relates; and

(ii) To pay administrative costs and other incidental expenses of the fund.

See paragraphs (c) and (d) of §1.468A-5 for rules relating to the deemed distribution of the assets of a nuclear decommissioning fund in the case of a disqualification or termination of the fund.

(2) *Exceptions to inclusion in gross income*—(i) *Payment of administrative costs and incidental expenses.* The amount of any payment by a nuclear decommissioning fund for administrative costs or other incidental expenses of such fund (as defined in paragraph (a)(3)(ii)(A) of §1.468A-5) shall not be included in the gross income of the electing taxpayer unless such amount is paid to the electing tax-

payer (in which case the amount of the payment is included in the gross income of the electing taxpayer under section 61).

(ii) *Withdrawals of excess contributions.* The amount of a withdrawal of an excess contribution (as defined in paragraph (c)(2)(ii) of §1.468A-5) by an electing taxpayer pursuant to the rules of paragraph (c)(2) of §1.468A-5 shall not be included in the gross income of the electing taxpayer. See paragraph (b)(1) of this section, which provides that the payment of such amount to the nuclear decommissioning fund is not deductible by the electing taxpayer.

(iii) *Actual distributions of amounts included in gross income as deemed distributions.* If the amount of a deemed distribution is included in the gross income of the electing taxpayer for the taxable year in which the deemed distribution occurs, no further amount is required to be included in gross income when the amount of the deemed distribution is actually distributed by the nuclear decommissioning fund. The amount of a deemed distribution is actually distributed by a nuclear decommissioning fund as the first actual distributions are made by the nuclear decommissioning fund on or after the date of the deemed distribution.

(e) *Deduction when economic performance occurs.* An electing taxpayer using an accrual method of accounting is allowed a deduction for nuclear decommissioning costs no earlier than the taxable year in which economic performance occurs with respect to such costs (see section 461(h)(2)). The amount of nuclear decommissioning costs that is deductible under this paragraph (e) is determined without regard to section 280B (see paragraph (b)(5) of §1.468A-1). A deduction is allowed under this paragraph (e) whether or not a deduction was allowed with respect to such costs under section 468A(a) and paragraph (a) of this section for an earlier taxable year (see paragraph (a)(2) of §1.468A-8, however, for the effective date applicable to this paragraph (e)).

(f) *Effect of interim rate orders and retroactive adjustments to such orders*—(1) *In general.* (i) The amount of decommissioning costs included in cost of service for any taxable year that ends before the date of a retroactive adjustment to an interim rate order or interim determination of a public utility commission shall include amounts authorized pursuant to such interim rate order or interim determination unless a taxpayer elects the application of paragraph (f)(2) of this section for such taxable year. For purposes of this paragraph (f), a retroactive adjustment occurs on the effective date of the revised rate schedule that implements the retroactive adjustment.

(ii) If a retroactive adjustment to an interim rate order or interim determination reduces the amount of decommissioning costs included in cost of service for one or more taxable years ending before the date of the adjustment, the amount of such reduction must be subtracted from the amount of decommissioning costs included in cost of service (as determined under paragraph (b)(2) of this section) for one or more taxable years ending on or after the date of the adjustment. For this purpose, the amount of such reduction must be taken into account in the following manner:

(A) If the retroactive adjustment reduces the amount of decommissioning costs included in cost of service for one taxable year ending before the date of the adjustment, the total amount of the reduction must be taken into account for the taxable year that includes the date of the adjustment.

(B) If the retroactive adjustment reduces the amount of decommissioning costs included in cost of service for two taxable years ending before the date of the adjustment, at least one-half of the total amount of the reduction must be taken into account for the first taxable year ending on or after the date of the adjustment and the total amount of the reduction must be taken into account over the first two taxable years ending on or after the date of the adjustment.

(C) If the retroactive adjustment reduces the amount of decommissioning costs included in cost of service for three or more taxable years ending before the date of the adjustment, at least one-third of the total amount of the reduction must be taken into account for the first taxable year ending on or after the date of the adjustment, at least two-thirds of the total amount of the reduction must be taken into account over the first two taxable years ending on or after the date of the adjustment, and the total amount of the reduction must be taken into account over the first three taxable years ending on or after the date of the adjustment.

(2) *Special rule permitting withdrawal of excess contribution that results from retroactive adjustment to interim rate order.* (i) If a retroactive adjustment that reduces the amount of decommissioning costs included in cost of service for a taxable year occurs on or before the date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for such taxable year, a taxpayer may elect the application of this paragraph (f)(2) for such taxable year by—

(A) Including in the amount of decommissioning costs included in cost of service for such taxable year only the amount of decommissioning costs authorized for such taxable year under the retroactive adjustment; and

(B) Withdrawing any excess contribution that results from such treatment in accordance with the rules of paragraph (c)(2) of §1.468A-5.

(ii) If a taxpayer elects the application of this paragraph (f)(2) for any taxable year, the retroactive adjustment shall not be treated for purposes of paragraph (f)(1)(ii) of this section as a reduction in the amount of decommissioning costs included in cost of service for such taxable year.

(3) *Revised schedule of ruling amounts.* If the rules provided in this paragraph (f) result in a cost of service amount applicable to a nuclear decommissioning fund for any taxable year that is less than the cost of service amount applicable to the nuclear decommissioning fund for the immediately preceding taxable year, the taxpayer must request a revised schedule of ruling amounts on or before the deemed

payment deadline date for the taxable year in which the retroactive adjustment occurs. The first taxable year to which the revised schedule of ruling amounts applies shall be the taxable year in which the retroactive adjustment occurs.

(4) *Example.* The following example illustrates the application of the principles of this paragraph (f):

Examples. (i) X corporation is a calendar year, accrual method taxpayer engaged in the sale of electric energy generated by a nuclear power plant owned by X. During 1989, X is authorized pursuant to an interim rate order issued by the public utility commission of State A to collect nuclear decommissioning costs of $500,000 per year beginning on January 1, 1990. On May 1, 1992, the public utility commission of State A issues a final rate order that is effective on July 1, 1992. The final rate order authorizes X to collect decommissioning costs of $400,000 per year and requires X to refund to the ratepayers of State A excess decommissioning costs of $250,000 collected between January 1, 1990, and July 1, 1992.

(ii) If X elects the application of paragraph (f)(2) of this section for the 1991 taxable year, the amount of decommissioning costs included in cost of service for such taxable year is $400,000. If X made a contribution of $500,000 to a nuclear decommissioning fund for the 1991 taxable year, X must withdraw $100,000 from the nuclear decommissioning fund on or before the date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for the 1991 taxable year (see paragraph (c)(2) of §1.468A-5).

(iii) In addition, under paragraph (f)(1)(i) of this section, the amount of decommissioning costs included in cost of service for the 1990 taxable year is $500,000, and, under paragraph (f)(1)(ii) of this section, the amount for the 1992 taxable year is $300,000. Because the cost of service amount for the 1991 taxable year ($400,000) is less than the cost of service amount for the 1990 taxable year ($500,000), paragraph (f)(3) of this section applies and X must file a request for a revised schedule of ruling amounts for the period beginning with the 1992 taxable year on or before March 15, 1993.

(iv) Alternatively, if X does not elect the application of paragraph (f)(2) of this section for the 1991 taxable year, under paragraph (f)(1)(i) of this section, the amount of decommissioning costs included in cost of service for the 1990 and 1991 taxable years is $500,000, and, under paragraph (f)(1)(ii) of this section, the amount of decommissioning costs included in cost of service for the 1992 taxable year may not exceed $300,000. Because the cost of service amount for the 1992 taxable year is less than the cost of service amount for the 1991 taxable year, paragraph (f)(3) of this section applies and X must file a request for a revised schedule of ruling amounts for the period beginning with the 1992 taxable year on or before March 15, 1993.

§1.468A-3 Ruling amount.

(a) *In general.* (1) Except as otherwise provided in paragraph (j) of this section, an electing taxpayer is allowed a deduction under section 468A(a) for the taxable year in which the taxpayer makes a cash payment (or is deemed to make a cash payment) to a nuclear decommissioning fund only if the taxpayer has received a schedule of ruling amounts for the nuclear decommissioning fund that includes a ruling amount for such taxable year. Except as provided in paragraph (a)(4) or (5) of this section, a schedule of ruling amounts for a nuclear decommissioning fund ("schedule of ruling amounts") is a ruling (within the meaning of paragraph (a)(2) of §601.201) specifying the annual payments ("ruling amounts") that, over the taxable years remaining in the "funding period" as of the date the schedule first applies, will result in a projected balance of the nuclear decommissioning fund as of the last day of the funding period equal to (and in no event greater than) the "amount of decommissioning costs allocable to the fund." The projected balance of a nuclear decommissioning fund as of the last day of the funding period shall be calculated by taking into account the fair market value of the assets of the fund as of the first day of the first taxable year to which the schedule of ruling amounts applies and the estimated rate of return to be earned by the assets of the fund after payment of the estimated administrative costs and incidental expenses to be incurred by the fund (as defined in paragraph (a)(3)(ii)(A) of §1.468A-5), including all Federal, State and local income taxes to be incurred by the fund (the "after-tax rate of return"). See paragraph (c) of this section for a definition of funding period and paragraph (d) of this section for guidance with respect to the amount of decommissioning costs allocable to a fund.

(2) To the extent consistent with the principles and provisions of this section, each schedule of ruling amounts shall be based on the reasonable assumptions and determinations used by the applicable public utility commission(s) in establishing or approving the amount of decommissioning costs to be included in cost of service for ratemaking purposes, taking into account amounts that are otherwise required to be included in the taxpayer's income under section 88 and the regulations thereunder. Thus, for example, each schedule of ruling amounts shall be based on the public utility commission's reasonable assumptions concerning—

(i) The after-tax rate of return to be earned by the amounts collected for decommissioning;

(ii) The total estimated cost of decommissioning the nuclear power plant (see paragraph (d)(2) of this section); and

(iii) The frequency of contributions to a nuclear decommissioning fund for a taxable year (*e.g.*, monthly, quarterly, semi-annual or annual contributions).

(3) The Internal Revenue Service shall provide a schedule of ruling amounts that is identical to the schedule of ruling amounts proposed by the taxpayer in connection with the taxpayer's request for a schedule of ruling amounts (see paragraph (h)(2)(viii) of this section), but no schedule of ruling amounts shall be provided unless the taxpayer's proposed schedule of ruling amounts is consistent with the principles and provisions of this section. If a proposed schedule of ruling amounts is not consistent with the principles and provisions of this section, the taxpayer may propose an amended schedule of ruling amounts that is consistent with such principles and provisions.

(4) If, in establishing or approving the amount of decommissioning costs to be included in cost of service for ratemaking purposes, the applicable public utility commission uses an estimated cost of decommissioning that is based on price levels in effect at the time of the ratemaking proceeding (*i.e.*, the public utility commission does not estimate the cost of decommissioning in future dollars), the Internal Revenue Service may, in its discretion, provide a formula or method for determining a schedule of ruling amounts (rather than a schedule specifying a dollar amount for each

taxable year) that is consistent with the principles and provisions of this section. See paragraph (i)(1)(ii) of this section for a special rule relating to the mandatory review of ruling amounts that are determined pursuant to a formula or method.

(5) The Internal Revenue Service may, in its discretion, provide a schedule of ruling amounts that is determined on a basis other than the rules of paragraphs (a) through (g) of this section if—

(i) In connection with its request for a schedule of ruling amounts, the taxpayer explains the need for special treatment and sets forth an alternative basis for determining the schedule of ruling amounts; and

(ii) The Internal Revenue Service determines that special treatment is consistent with the purpose of section 468A.

(b) *Level funding limitation.* (1) Except as otherwise provided in paragraph (b)(4) of this section and paragraph (b)(6) of §1.468A-8 (relating to a special transitional rule), the ruling amount specified in a schedule of ruling amounts for any taxable year in the level funding limitation period shall not be less than the ruling amount specified in such schedule for any earlier taxable year.

(2) For purposes of this section, the level funding limitation period for a nuclear decommissioning fund is the period that—

(i) Begins on the first day of the first taxable year for which a deductible payment is made (or deemed made) to such nuclear decommissioning fund (see paragraph (a) of §1.468A-2 for rules relating to the first taxable year for which a payment may be made (or deemed made) to a nuclear decommissioning fund); and

(ii) Ends on the last day of the taxable year that includes the estimated date on which the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base for ratemaking purposes (see paragraph (e)(2) and (4) of this section).

(3) The ruling amount specified in a schedule of ruling amounts for a taxable year after the end of the level funding limitation period may be less than the ruling amount specified in such schedule for an earlier taxable year.

(4) The ruling amount specified in a schedule of ruling amounts for the last taxable year in the level funding limitation period may be less than the ruling amount specified in such schedule for any earlier taxable year if the applicable public utility commission assumes for cost of service purposes that decommissioning costs will be included in cost of service for only a portion of the last taxable year in the level funding limitation period. The ruling amount for the last taxable year in the level funding limitation period, however, may not be less than the amount that bears the same relationship to the ruling amount for the preceding taxable year as the period for which decommissioning costs will be included in cost of service for such last taxable year bears to one year.

(c) *Funding period—*(1) *General rule.* For purposes of this section, the funding period for a nuclear decommissioning fund is the period that—

(i) Begins on the first day of the first taxable year for which a deductible payment is made (or deemed made) to such nuclear decommissioning fund (see paragraph (a)(1) of §1.468A-2 for rules relating to the first taxable year for which a payment may be made (or deemed made) to a nuclear decommissioning fund); and

(ii) Ends on the later of—

(A) The last day of the taxable year that includes the estimated date on which decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's cost of service for ratemaking purposes (see paragraph (e)(1) of this section); or

(B) The last day of the taxable year that includes the estimated date on which the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base for ratemaking purposes (see paragraph (e)(2) of this section).

(2) *Examples.* The following examples illustrate the application of the principles of paragraphs (a), (b), and (c) of this section:

Example (1). (i) X corporation is a calendar year, accrual method taxpayer engaged in the sale of electric energy generated by power plants owned by X. On March 15, 1995, X commences the construction of a nuclear power plant in State A. On May 15, 1995, the public utility commission of State A issues a final rate order for the four-year period beginning on January 1, 1995, that authorizes X to collect decommissioning costs from ratepayers residing in State A. For the 1995 taxable year, X is authorized to collect decommissioning costs of $500,000, and, for each taxable year during the remainder of the period to which the rate order applies, X is authorized to collect decommissioning costs in an amount equal to 105 percent of the amount authorized to be collected for the preceding taxable year.

(ii) In determining the amount of decommissioning costs to be collected from ratepayers residing in State A, the public utility commission assumes that (A) decommissioning costs will be included in cost of service for each taxable year in the period that begins with 1995 and ends with 2025 and (B) decommissioning costs collected pursuant to subsequent rate orders will increase in the same manner as amounts collected pursuant to the rate order issued on May 15, 1995. In addition, in determining the rate of return to be earned by X with respect to the nuclear power plant, the public utility commission assumes that the nuclear power plant will be included in rate base for each year in the period that begins with 2000 and ends with 2025.

(iii) X requests a schedule of ruling amounts in accordance with the rules of paragraph (h) of this section for the period beginning with the 1995 taxable year. In determining the level funding limitation period and the funding period, the Internal Revenue Service shall assume that a deductible payment will be made to a nuclear decommissioning fund for the 1995 taxable year. Thus, under paragraph (b) of this section, the level funding limitation period begins on January 1, 1995, and ends on December 31, 2025. Under paragraph (c)(10 of this section, the funding period begins on January 1, 1995, and ends on December 31, 2025.

(iv) In its request for a schedule of ruling amounts, X proposes a ruling amount for each taxable year in the funding period that corresponds to the projected cost of service amount for such taxable year. If (A) the assumptions and determinations used by the public utility commission in establishing the amount of decommissioning costs to be included in cost of service are reasonable and (B) the amounts collected pursuant to the proposed schedule, combined with the after-tax earnings on such amounts, will result in a projected balance of the nuclear decommissioning fund as of December 31, 2025, equal to the amount of decommissioning costs allocable to the fund, then, under paragraph (a)(3) of this section, each ruling amount in the initial schedule of ruling amounts shall equal the ruling amount proposed by X in connection with its request for a schedule of ruling amounts. Thus, the ruling amount for the 1995 taxable year would be $500,000, and the ruling amount for each subsequent taxable year would be 105 percent of the ruling amount for the preceding taxable year.

Example (2). (i) Assume the same facts as in Example (1), except that on May 15, 1995, the public utility commission of State A issues a final rate order for the four-year period beginning on January 1, 1995, that authorizes X to collect decommissioning costs of $600,000 per year from ratepayers residing in State A. In determining the amount of decommissioning costs to be collected from ratepayers residing in State A, the public utility commission assumes that decommissioning costs of $600,000 will be collected for each taxable year in the period that begins with 1995 and ends with 2004 and that decommissioning costs of $200,000 will be collected for each taxable year in the period that begins with 2005 and ends with 2025.

(ii) X requests a schedule of ruling amounts in accordance with the rules of paragraph (h) of this section for the period beginning with the 1995 taxable year. In determining the level funding limitation period and the funding period, the Internal Revenue Service shall assume that a deductible payment will be made to a nuclear decommissioning fund for the 1995 taxable year. Thus, under paragraph (b) of this section, the level funding limitation period begins on January 1, 1995, and ends on December 31, 2025. Under paragraph (c)(1) of this section, the funding period begins on January 1, 1995, and ends on December 31, 2025.

(iii) In its request for a schedule of ruling amounts, X proposes a ruling amount for each taxable year in the funding period that corresponds to the projected cost of service amount for such taxable year. A schedule of ruling amounts based on the projected cost of service amount would be inconsistent with the level funding limitation of paragraph (b) of this section because the projected cost of service amount for 2005 is less than the projected cost of service amount for 2004. Consequently, under paragraph (a)(3) of this section, no schedule of ruling amounts shall be provided to X unless X proposes an amended schedule of ruling amounts that is consistent with the level funding limitation and the other principles and provisions of this section.

(iv) Assume that X proposes an amended schedule of ruling amounts that provides for ruling amounts of $400,000 for each taxable year in the funding period. If (A) the schedule of ruling amounts proposed by X is based on the reasonable assumptions and determinations used by the public utility commission in establishing the amount of decommissioning costs to be included in cost of service and (B) the amounts collected pursuant to the proposed schedule, combined with the after-tax earnings on such amounts, will result in a projected balance of the nuclear decommissioning fund as of December 31, 2025, equal to the amount of decommissioning costs allocable to the fund, then, under paragraph (a)(3) of this section, each ruling amount in the initial schedule of ruling amounts shall equal the ruling amount proposed by X in connection with its request for a schedule of ruling amounts. Thus, the ruling amount for the 1995 taxable year and for each subsequent taxable year through 2025 would be $400,000.

(v) Under section 468A(b) and paragraph (b)(1) of §1.468A-2, the maximum amount of cash payments that X can make to a nuclear decommissioning fund for any taxable year shall not exceed the lesser of (A) the cost of service amount for such taxable year or (B) the ruling amount for such taxable year. If the projected cost of service amount that was assume in determining rates under the rate order that was issued on May 15, 1995, is the actual cost of service amount for each taxable year in the funding period and the ruling amounts provided in the initial schedule of ruling amounts are not changed by a subsequent schedule of ruling amounts, then X would be allowed to make a deductible contribution of $400,000 to a nuclear decommissioning fund for each taxable year in the period that begins with 1995 and ends with 2004 and to make a deductible contribution of $200,000 to such nuclear decommissioning fund for each taxable year in the period that begins with 2005 and ends with 2025.

Example (3). (i) Y corporation is a calendar year, accrual method taxpayer engaged in the sale of electric energy generated by power plants owned by Y. On June 1, 1990, a nuclear power plant owned by Y began commercial operations in State B. In the first ratemaking proceeding in which the nuclear power plant was included in rate base, the public utility commission of State B assumed that the nuclear power plant would be included in rate base for each year in the period that began with 1990 and ended with 2020. In addition, for each taxable year in the period that began with 1990 and ended with 2017, Y made a deductible contribution of $750,000 to a nuclear decommissioning fund established by Y. The $750,000 contribution equalled the cost of service amount and the ruling amount for each taxable year in the 28-year period.

(ii) On August 30, 2017, the public utility commission of State B issues a final rate order for the six-year period beginning on January 1, 2018, that authorizes Y to collect decommissioning costs of: (A) $500,000 for 2018, 2019 and 2020; (B) $1,500,000 for 2021; (C) $1,000,000 for 2022; and (D) $750,000 for 2023. In determining the amount of decommissioning costs to be collected from ratepayers residing in State B, the public utility commission assumes that decommissioning costs will no longer be included in cost of service after 2023. In addition, in determining the rate of return to be earned by Y with respect to the nuclear power plant, the public utility commission assumes that the nuclear power plant will no longer be included in rate base after 2020.

(iii) Under paragraph (i)(1)(iii) of this section, Y is required to request a revised schedule of ruling amounts on or before March 15, 2019. Assume that Y makes a timely request for a revised schedule of ruling amounts in accordance with the rules of paragraph (h) of this section. In its request, Y proposes a ruling amount for each taxable year in the period that begins with 2018 and ends with 2023 that corresponds to the amount of decommissioning costs to be included in cost of service under the rate order of August 30, 2017.

(iv) Under paragraph (b) of this section, the level funding limitation period begins on January 1, 1990, and ends on December 31, 2020. Under paragraph (c)(1) of this section, the funding period begins on January 1, 1990, and ends on December 31, 2023.

(v) If (A) the assumptions and determinations used by the public utility commission in establishing the amount of decommissioning costs to be included in cost of service are reasonable and (B) the projected balance of the nuclear decommissioning fund as of December 31, 2023 (taking into account the fair market value of the assets of the fund as of January 1, 2018, and the estimated after-tax rate of return to be earned by the assets of the fund) will equal the amount of decommissioning costs allocable to the fund, then, under paragraph (a)(3) of this section, each ruling amount in the revised schedule of ruling amounts shall equal the ruling amount proposed by Y in connection with its request for a schedule of ruling amounts. Thus, the ruling amount for 2018, 2019 and 2020 would be $500,000, the ruling amount for 2021 would be $1,500,000, the ruling amount for 2022 would be $1,000,000 and the ruling amount for 2023 would be $750,000.

(vi) Although the ruling amount specified in the revised schedule of ruling amounts for 2018, 2019 and 2020 is less than a ruling amount specified in a prior schedule of ruling amounts for years prior to 2018, the revised schedule of ruling amounts is consistent with the level funding limitation. Under paragraph (i)(3) of this section, a ruling amount specified in a revised schedule of ruling amounts for any taxable year in the level funding limitation period may be less than one or more ruling amounts specified in a prior schedule of ruling amounts for a prior taxable year. In addition, although the ruling amount specified in the revised schedule of ruling amounts for 2022 and 2023 is less than a ruling amount specified in such schedule for a prior taxable year, the revised schedule of ruling amounts is consistent with the level funding limitation because the level funding limitation period ends on December 31, 2020.

(d) *Decommissioning costs allocable to a fund.* The amount of decommissioning costs allocable to a nuclear decommissioning fund is determined for purposes of this section by applying the following rules and definitions:

(1) *General rule.* The amount of decommissioning costs allocable to a nuclear decommissioning fund is the taxpayer's share of the total estimated cost of decommissioning the nuclear power plant to which the fund relates, multiplied by the qualifying percentage.

(2) *Total estimated cost of decommissioning.* (i) Except as other-

wise provided in paragraph (d)(2)(ii) of this section, the total estimated cost of decommissioning a nuclear power plant is the reasonably estimated cost of decommissioning used by the applicable public utility commission in establishing or approving the amount of decommissioning costs to be included in cost of service for ratemaking purposes. If, in establishing or approving the amount of decommissioning costs to be included in cost of service, the public utility commission uses an estimated cost of decommissioning that is equal to a generic estimate of the cost of decommissioning as determined by the Nuclear Regulatory Commission (or an estimated cost that is based on the generic estimate adjusted for inflation), the Internal Revenue Service may, at its discretion, accept such amount as a reasonable estimate of the cost of decommissioning. In addition, if the estimated costs used by the applicable public utility commission are expected to be paid in any taxable year other than the taxable year that includes the last day of the funding period or the immediately succeeding taxable year, such costs may be adjusted (increased or decreased, as the case may be) by discounting or compounding such costs at the after-tax rate of return from the date such costs are expected to be paid to the last day of the funding period.

(ii) If, in establishing or approving the amount of decommissioning costs to be included in cost of service, the applicable public utility commission assumes a projected balance of amounts set aside for decommissioning (whether or not such amounts are provided by a nuclear decommissioning fund) that is less than the total estimated cost of decommissioning assumed by the public utility commission, the total estimated cost of decommissioning for purposes of determining the schedule of ruling amounts shall equal the projected balance of amounts set aside for decommissioning that was assumed by the public utility commission.

(3) *Taxpayer's share.* The taxpayer's share of the total estimated cost of decommissioning a nuclear power plant equals the total estimated cost of decommissioning such nuclear power plant multiplied by the percentage of such nuclear power plant that the qualifying interest of the taxpayer represents (see paragraph (b)(2) of §1.468A-1 for circumstances in which a taxpayer possesses a qualifying interest in a nuclear power plant).

(4) *Qualifying percentage.* (i) Except as otherwise provided in paragraph (b)(7)(iii) of §1.468A-8 (relating to a special transitional rule), the qualifying percentage for any nuclear decommissioning fund is equal to the fraction, the numerator of which is the number of taxable years in the estimated period for which the nuclear decommissioning fund is to be in effect and the denominator of which is the number of taxable years in the estimated useful life of the applicable nuclear power plant.

(ii) Except as otherwise provided in paragraph (b)(7)(i) or (ii) of §1.468A-8 (relating to special transitional rules), the estimated period for which a nuclear decommissioning fund is to be in effect—

(A) Begins on the later of—

(*1*) The first day of the first taxable year for which a deductible payment is made (or deemed made) to such nuclear decommissioning fund; or

(*2*) The first day of the taxable year that includes the date that the nuclear power plant to which such nuclear decommissioning fund relates begins commercial operations; and

(B) Ends on the last day of the taxable year that includes the estimated date on which the nuclear power plant to which such nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base for ratemaking purposes (see paragraph (e)(3) and (4) of this section).

(iii) Except as otherwise provided in paragraph (b)(7)(ii) of §1.468A-8 (relating to a special transitional rule), the estimated useful life of a nuclear power plant—

(A) Begins on the first day of the taxable year that includes the date that the nuclear power plant begins commercial operations; and

(B) Ends on the last day of the taxable year that includes the estimated date on which the nuclear power plant will no longer be included in the taxpayer's rate base for ratemaking purposes (see paragraph (e)(3) and (4) of this section).

(e) *Determination of estimated dates.* (1) For purposes of paragraph (c)(1)(ii)(A) of this section (relating to the funding period), the estimated date on which decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's cost of service for ratemaking purposes is determined under the ratemaking assumptions that were used to determine the last rates (whether interim or final) that were established or approved by the applicable public utility commission prior to the filing of the current request for a schedule of ruling amounts.

(2) For purposes of paragraphs (b)(2)(ii) and (c)(1)(ii)(B) of this section (relating to the level funding limitation period and the funding period), the estimated date on which the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base for ratemaking purposes is determined under the ratemaking assumptions that were used to determine the last rates (whether interim or final) that were established or approved by the applicable public utility commission prior to the filing of the current request for a schedule of ruling amounts.

(3) For purposes of paragraph (d)(4)(ii)(B) and (iii)(B) of this section (relating to the qualifying percentage), the estimated date on which the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base for ratemaking purposes is determined under the ratemaking assumptions used by the applicable public utility commission in establishing or approving rates during the first ratemaking proceeding in which the nuclear power plant was included in the taxpayer's rate base.

(4) For purposes of this section, in the case of a taxpayer whose interest in the nuclear power plant is described in paragraph (b)(2)(ii) of §1.468A-1, the date correspond-

ing to "the estimated date on which the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base" will be determined upon the basis of all the facts and circumstances in a manner consistent with the provisions of this section and section 468A of the Code.

(f) *Special rules in the case of rates established or approved by two or more public utility commissions.* If two or more public utility commissions establish or approve rates for electric energy generated by a single nuclear power plant, the following rules shall apply in determining the schedule of ruling amounts for the nuclear decommissioning fund that relates to such nuclear power plant:

(1) A schedule of ruling amounts shall be separately determined pursuant to the rules of paragraphs (a) through (e) of this section for each public utility commission that has determined the amount of decommissioning costs to be included in cost of service for ratemaking purposes with respect to such nuclear power plant (see paragraph (g) of this section).

(2) The separate determination with respect to a public utility commission shall be based on the reasonable assumptions and determinations used by such public utility commission and shall take into account only that portion of the total estimated cost of decommissioning the nuclear power plant that is properly allocable to the ratepayers whose rates are established or approved by such public utility commission.

(3) The ruling amount applicable to the nuclear decommissioning fund for any taxable year is the sum of the ruling amounts for such taxable year determined under the separate schedules of ruling amounts.

(4) The schedule of ruling amounts for the nuclear decommissioning fund is the schedule of the ruling amounts determined under paragraph (f)(3) of this section.

(g) *Requirement of determination by public utility commission of decommissioning costs to be included in cost of service.* The Internal Revenue Service shall not provide a taxpayer with a schedule of ruling amounts for any nuclear decommissioning fund unless a public utility commission that establishes or approves rates for electric energy generated by the nuclear power plant to which the nuclear decommissioning fund relates has—

(1) Determined the amount of decommissioning costs of such nuclear power plant to be included in the taxpayer's cost of service for ratemaking purposes; and

(2) Disclosed the after-tax return and any other assumptions and determinations used in establishing or approving such amount for any taxable year beginning on or after January 1, 1987.

(h) *Manner of requesting schedule of ruling amounts*—(1) *In general.* (i) In order to receive a ruling amount for any taxable year, a taxpayer must file a request for a schedule of ruling amounts that complies with the requirements of this paragraph (h), the applicable procedural rules set forth in paragraph (e) of §601.201 (Statement of Procedural Rules) and the requirements of any applicable revenue procedure that is in effect on the date the request is filed.

(ii) A separate request for a schedule of ruling amounts is required for each nuclear decommissioning fund established by a taxpayer (see paragraph (a) of §1.468A-5 for rules relating to the number of nuclear decommissioning funds that a taxpayer can establish).

(iii) A request for a schedule of ruling amounts must not contain a request for a ruling on any other issue, whether the issue involves section 468A or another section of the Internal Revenue Code.

(iv) In the case of an affiliated group of corporations that join in the filing of a consolidated return, the common parent of the group may request a schedule of ruling amounts for each member of the group that possesses a qualifying interest in the same nuclear power plant by filing a single submission with the Internal Revenue Service.

(v) A request for a schedule of ruling amounts must be mailed or delivered to the Internal Revenue Service, Associate Chief Counsel (Technical), Attention CC:C:2:6, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

(vi) Except as otherwise provided in paragraph (b)(1) of §1.468A-8, the Internal Revenue Service shall not provide or revise a ruling amount applicable to a taxable year in response to a request for a schedule of ruling amounts that is filed after the deemed payment deadline date (as defined in paragraph (c)(1) of §1.468A-2) for such taxable year. In determining the date when a request is filed, the principles of sections 7502 and 7503 shall apply.

(vii) Except as provided in paragraph (h)(1)(viii) of this section, a request for a schedule of ruling amounts shall be considered filed only if such request complies substantially with the requirements of this paragraph (h).

(viii) If a request does not comply substantially with the requirements of this paragraph (h), the Internal Revenue Service shall notify the taxpayer of this fact. If the information or materials necessary to comply substantially with the requirements of this paragraph (h) are provided to the Internal Revenue Service within 60 days after such notification, the request shall be considered filed on the date of original submission. If the information or materials necessary to comply substantially with the requirements of this paragraph (h) are not provided within 60 days after such notification, the request shall be considered filed on the date that all information or materials necessary to comply substantially with the requirements of this paragraph (h) are provided.

(2) *Information required.* A request for a schedule of ruling amounts must contain the following information:

(i) The taxpayer's name, address and taxpayer identification number.

(ii) Whether the request is for an initial schedule of ruling amounts, a mandatory review of the schedule of ruling amounts (see paragraph (i)(1) of this section) or an elective review of the schedule of ruling amounts (see paragraph (i)(2) of this section).

(iii) The name and location of the nuclear power plant with respect to which a schedule of ruling amounts is requested.

(iv) A description of the taxpayer's qualifying interest in the nuclear power plant and the percentage of such nuclear power plant that the qualifying interest of the taxpayer represents.

(v) An identification of each public utility commission that establishes or approves rates for the furnishing or sale by the taxpayer of electric energy generated by the nuclear power plant, and, for each public utility commission identified—

(A) Whether the public utility commission has determined the amount of decommissioning costs to be included in the taxpayer's cost of service for ratemaking purposes; and

(B) Whether a proceeding is pending before the public utility commission that may result in an increase or decrease in the amount of decommissioning costs to be included in cost of service.

(vi) For each public utility commission that has determined the amount of decommissioning costs to be included in the taxpayer's cost of service for ratemaking purposes—

(A) The amount of decommissioning costs that are to be included in the taxpayer's cost of service for each taxable year under the current determination and amounts that otherwise are required to be included in the taxpayer's income under section 88 and the regulations thereunder;

(B) A description of the assumptions, estimates and other factors that were used in determining the amounts described in paragraph (h)(2)(vi)(A) of this section, including each of the following if applicable—

(*1*) A description of the proposed method of decommissioning the nuclear power plant (for example, prompt removal/dismantlement, safe storage entombment with delayed dismantlement, or safe storage mothballing with delayed dismantlement);

(*2*) The estimated year in which substantial decommissioning costs will first be incurred;

(*3*) The estimated year in which the decommissioning of the nuclear power plant will be substantially complete (see paragraph (d)(2) of §1.468A-5 for a definition of substantial completion of decommissioning);

(*4*) The total estimated cost of decommissioning expressed in current dollars (*i.e.*, based on price levels in effect at the time of the current determination);

(*5*) The total estimated cost of decommissioning expressed in future dollars (*i.e.*, based on anticipated price levels when expenses are expected to be paid);

(*6*) For each taxable year in the period that begins with the year specified in paragraph (h)(2)(vi)(B)(*2*) of this section ("the estimated year in which substantial decommissioning costs will first be incurred") and ends with the year specified in paragraph (h)(2)(vi)(B)(*3*) of this section ("the estimated year in which the decommissioning of the nuclear ower plant will be substantially complete"), the estimated cost of decommissioning expressed in future dollars;

(*7*) A description of the methodology used in converting the estimated cost of decommissioning expressed in current dollars to the estimated cost of decommissioning expressed in future dollars;

(*8*) The assumed after-tax rate of return to be earned by the amounts collected for decommissioning (if two or more after-tax rates of return are assumed by the public utility commission, each assumed after-tax rate of return and the amounts collected for decommissioning to which each assumed after-tax rate of return applies);

(*9*) The proposed period over which decommissioning costs will be included in the cost of service of the taxpayer and the projected amount that will be included in cost of service for each taxable year in the proposed period;

(*10*) The estimated date on which the nuclear power plant will no longer be included in the taxpayer's rate base for ratemaking purposes as determined under the ratemaking assumptions that were used to determine the last rates (whether interim or final) that were established or approved by the applicable public utility commission prior to the filing of the current request for a schedule of ruling amounts (or a corresponding date in the case of a taxpayer whose interest in the nuclear power plant is described in paragraph (b)(2)(ii) of §1.468A-1; see paragraph (e)(4) of this section); and

(*11*) The estimated date on which the nuclear power plant will no longer be included in the taxpayer's rate base for ratemaking purposes as determined under the ratemaking assumptions that were used by the applicable public utility commission in establishing or approving rates during the first ratemaking proceeding in which the nuclear power plant was included in the taxpayer's rate base (or a corresponding date in the case of a taxpayer whose interest in the nuclear power plant is described in paragraph (b)(2)(ii) of §1.468A-1; see paragraph (e)(4) of this section);

(C) A copy of such portions of any order or opinion of the public utility commission as pertain to the commission's most recent determination of the amount of decommissioning costs to be included in cost of service; and

(D) A copy of each engineering or cost study that was relied on or used by the taxpayer or the public utility commission in determining the amount of decommissioning costs to be included in the taxpayer's cost of service under the current determination.

(vii) For each proceeding pending before a public utility commission that may result in an increase or decrease in the amount of decommissioning costs to be included in the taxpayer's cost of service—

(A) A description of the stage of the proceeding;

(B) The amount of decommissioning costs that are proposed to be included in the taxpayer's cost of service for each taxable year;

(C) A description of the assumptions, estimates and other factors that were used in determining the amount of decommissioning costs that are proposed to be included in the taxpayer's cost of service for each taxable year, including each of the items described in paragraph (h)(2)(vi)(B) of this section if applicable; and

(D) A copy of each engineering or cost study that was relied on or used by the taxpayer or the public utility commission in determining the amount of decommissioning costs that are proposed to be included in the taxpayer's cost of service.

(viii) A proposed schedule of ruling amounts for each taxable year remaining in the funding period as of the date the schedule of ruling amounts will first apply.

(ix) A description of the assumptions, estimates and other factors that were used in determining the proposed schedule of ruling amounts, including each of the following if applicable—

(A) The level funding limitation period (as such term is defined in paragraph (b)(2) of this section);

(B) The funding period (as such term is defined in paragraph (c) of this section);

(C) The assumed after-tax rate of return to be earned by the assets of the nuclear decommissioning fund;

(D) The fair market value of the assets (if any) of the nuclear decommissioning fund as of the first day of the first taxable year to which the schedule of ruling amounts will apply;

(E) The amount expected to be earned by the assets of the nuclear decommissioning fund (based on the after-tax rate of return applicable to the fund) over the period that begins on the first day of the first taxable year to which the schedule of ruling amounts will apply and ends on the last day of the funding period;

(F) The amount of decommissioning costs allocable to the nuclear decommissioning fund (as determined under paragraph (d) of this section);

(G) The total estimated cost of decommissioning (as such term is defined in paragraph (d)(2) of this section);

(H) The taxpayer's share of the total estimated cost of decommissioning (as such term is defined in paragraph (d)(3) of this section);

(I) The qualifying percentage (as such term is defined in paragraph (d)(4)(i) of this section);

(J) The estimated period for which the nuclear decommissioning fund is to be in effect (as such term is defined in paragraph (d)(4)(ii) of this section); and

(K) The estimated useful life of the nuclear power plant (as such term is defined in paragraph (d)(4)(iii) of this section).

(x) If the request is for a revised schedule of ruling amounts, the after-tax rate of return earned by the assets of the nuclear decommissioning fund for each taxable year in the period that begins with the date of the initial contribution to the fund and ends with the first day of the first taxable year to which the revised schedule of ruling amounts applies.

(xi) If applicable, an explanation of the need for a schedule of ruling amounts determined on a basis other than the rules of paragraphs (a) through (g) of this section and a description of an alternative basis for determining a schedule of ruling amounts (see paragraph (a)(5) of this section).

(xii) Any other information required by the Internal Revenue Service that may be necessary or useful in determining the schedule of ruling amounts.

(3) *Administrative procedures.* The Internal Revenue Service may prescribe administrative procedures that supplement the provisions of paragraph (h)(1) and (2) of this section. In addition, the Internal Revenue Service may, in its discretion, waive the requirements of paragraph (h)(1) and (2) of this section under appropriate circumstances.

(i) *Review and revision of schedule of ruling amounts*—(1) *Mandatory review.* (i) Any taxpayer that has obtained a schedule of ruling amounts pursuant to paragraph (h) of this section must file a request for a revised schedule of ruling amounts on or before the deemed payment deadline date for the 10th taxable year that begins after the taxable year in which the most recent schedule of ruling amounts was received. The first taxable year to which the revised schedule of ruling amounts applies shall be the 10th taxable year that begins after the taxable year in which the most recent schedule of ruling amounts was received.

(ii) Any taxpayer that has obtained a formula or method for determining a schedule of ruling amounts (see paragraph (a)(4) of this section) must file a request for a revised schedule of ruling amounts on or before the deemed payment deadline date for the 5th taxable year that begins after the taxable year in which the most recent formula or method was received. The first taxable year to which the revised schedule of ruling amounts applies (whether or not the ruling amounts continue to be determined pursuant to a formula or method) shall be the 5th taxable year that begins after the taxable year in which the most recent formula or method was received.

(iii) A taxpayer is required to request a revised schedule of ruling amounts for a nuclear decommissioning fund if—

(A) Any public utility commission that establishes or approves rates for the furnishing or sale of electric energy generated by a nuclear power plant to which the nuclear decommissioning fund relates—

(*1*) Increases the proposed period over which decommissioning costs of such nuclear power plant will be included in cost of service for ratemaking purposes;

(*2*) Adjusts the estimated date on which such nuclear power plant will no longer be included in the taxpayer's rate base for ratemaking purposes; or

(*3*) Reduces the amount of decommissioning costs to be included in cost of service for any taxable year; and

(B) The taxpayer's most recent request for a schedule of ruling amounts did not provide notice to the Internal Revenue Service of such action by the public utility commission.

(iv) If a taxpayer is required to request a revised schedule of ruling amounts by reason of an action described in paragraph (i)(1)(iii) of this section, the taxpayer must file the request for a revised schedule of ruling amounts on or before the deemed payment deadline date for the first taxable year in which rates that reflect such action become effective. The first taxable year to which the revised schedule of ruling amounts applies shall be the first taxable year in which such rates become effective.

(v) A request for a schedule of ruling amounts required by this paragraph (i)(1) must be made in accordance with the rules of paragraph (h) of this section. If a taxpayer does not properly file a request for a revised schedule of ruling amounts by the date provided in paragraph (i)(1)(i), (ii) or (iv) of this section (whichever is applicable), the taxpayer's ruling amount for the first taxable year to which the revised schedule of ruling amounts would have applied and for all succeeding taxable years until a new schedule is obtained shall be zero, unless, in its discretion, the Internal Revenue Service provides otherwise in such new schedule of ruling amounts.

(vi) See paragraph (f)(3) of §1.468A-2 for the application of the rules in paragraph (i)(1)(iii), (iv), and (v) of this section in the case of certain retroactive adjustments to interim rate orders.

(2) *Elective review.* Any taxpayer that has obtained a schedule of ruling amounts pursuant to paragraph (h) of this section can request a revised schedule of ruling amounts. Such a request must be made in accordance with the rules of paragraph (h) of this section; thus, the Internal Revenue Service shall not provide a revised ruling amount applicable to a taxable year in response to a request for a schedule of ruling amounts that is filed after the deemed payment deadline date for such taxable year (see paragraph (h)(1)(vi) of this section).

(3) *Determination of revised schedule of ruling amounts.* A revised schedule of ruling amounts for a nuclear decommissioning fund shall be determined under this section without regard to any schedule of ruling amounts for such nuclear decommissioning fund that was issued prior to such revised schedule. Thus, a ruling amount specified in a revised schedule of ruling amounts for any taxable year in the level funding limitation period can be less than one or more ruling amounts specified in a prior schedule of ruling amounts for a prior taxable year.

(j) *Special rule permitting payments to a nuclear decommissioning fund before receipt of an initial or revised ruling amount applicable to a taxable year.* (1) If an electing taxpayer has filed a timely request for an initial or revised ruling amount for a taxable year beginning on or after January 1, 1987, and does not receive the ruling amount on or before the deemed payment deadline date for such taxable year, the taxpayer may make a payment to a nuclear decommissioning fund on the basis of the ruling amount proposed in the taxpayer's request. Thus, under the preceding sentence, an electing taxpayer may make a payment to a nuclear decommissioning fund for such taxable year that does not exceed the lesser of—

(i) The cost of service amount applicable to the nuclear decommissioning fund for such taxable year; or

(ii) The ruling amount proposed by the taxpayer for such taxable year in a timely filed request for a schedule of ruling amounts.

(2) If an electing taxpayer makes a payment to a nuclear decommissioning fund for any taxable year pursuant to paragraph (j)(1) of this section and the ruling amount that is provided by the Internal Revenue Service is greater than the ruling amount proposed by the taxpayer for such taxable year, the taxpayer is not allowed to make an additional payment to the fund for such taxable year after the deemed payment deadline date for such taxable year.

(3) If—

(i) An electing taxpayer makes a payment to a nuclear decommissioning fund for any taxable year pursuant to paragraph (j)(1) of this section,

(ii) The ruling amount that is provided by the Internal Revenue Service is less than the ruling amount proposed by the taxpayer for such taxable year, and

(iii) As a result, there is an excess contribution (as defined in paragraph (c)(2)(ii) of §1.468A-5) for such taxable year,

then the amount of the excess contribution is not deductible (see paragraph (b)(1) of §1.468A-2) and must be withdrawn by the taxpayer pursuant to the rules of paragraph (c)(2)(i) of §1.468A-5. Thus, an electing taxpayer that files a return based on a payment made pursuant to paragraph (j)(1) of this section should file an amended return if an excess contribution results when the ruling amount is issued for such taxable year.

§1.468A-4 Treatment of nuclear decommissioning fund.

(a) *In general.* A nuclear decommissioning fund is subject to tax on all of its modified gross income (as defined in paragraph (b) of this section) for any taxable year at a single rate equal to the maximum rate in effect under section 11(b) (determined without regard to any rate that is added to the otherwise applicable rate in order to offset the effect of the graduated rate schedule). Such tax is in lieu of any other tax that may be imposed under subtitle A of the Internal Revenue Code on the income earned by the assets of the nuclear decommissioning fund.

(b) *Modified gross income.* For purposes of this section, the term "modified gross income" means gross income as defined under section 61 computed with the following modifications:

(1) The amount of any payment to the nuclear decommissioning fund with respect to which a deduction is allowed under section 468A(a) is excluded from gross income.

(2) A deduction is allowed for the amount of administrative costs and other incidental expenses of the nuclear decommissioning fund (including taxes, legal expenses, accounting expenses, actuarial expenses and trustee expenses, but not including decommissioning costs) that are otherwise deductible and that are paid by the nuclear decommissioning fund to any person other than the electing taxpayer. An expense is otherwise deductible for purposes of this paragraph (b)(2) if it would be deductible under chapter 1 of the Internal Revenue Code in determin-

ing the taxable income of a corporation. For example, because Federal income taxes are not deductible under chapter 1 of the Internal Revenue Code in determining the taxable income of a corporation, the tax imposed by section 468A(e)(2) and paragraph (a) of this section is not deductible in determining the modified gross income of a nuclear decommissioning fund. Similarly, because certain expenses allocable to tax-exempt interest income are not deductible under section 265 of the Internal Revenue Code in determining the taxable income of a corporation, such expenses are not deductible in determining the modified gross income of a nuclear decommissioning fund.

(3) A deduction is allowed for the amount of otherwise deductible losses that are sustained by the nuclear decommissioning fund in connection with the sale, exchange or worthlessness of an investment described in paragraph (a)(3)(i)(C) of §1.468A-5. A loss is otherwise deductible for purposes of this paragraph (b)(3) if such a loss would be deductible by a corporation under section 165(f) or (g) and sections 1211(a) and 1212(a).

(4) A deduction is allowed for the amount of an otherwise deductible net operating loss of the nuclear decommissioning fund. For purposes of this paragraph (b), the net operating loss of a nuclear decommissioning fund for a taxable year is the amount by which the deductions allowable under paragraph (b)(2) and (3) of this section exceed the gross income of the nuclear decommissioning fund computed with the modification described in paragraph (b)(1) of this section. A net operating loss is otherwise deductible for purposes of this paragraph (b)(4) if such a net operating loss would be deductible by a corporation under section 172(a).

(c) *Special rules*—(1) *Period for computation of modified gross income.* The modified gross income of a nuclear decommissioning fund must be computed on the basis of the taxable year of the electing taxpayer. If an electing taxpayer changes its taxable year, each nuclear decommissioning fund of the electing taxpayer must change to the new taxable year. See section 442 and §1.442-1 for rules relating to the change to a new taxable year.

(2) *Gain or loss upon distribution of property by a fund.* A distribution of property by a nuclear decommissioning fund (whether an actual distribution or a deemed distribution) shall be considered a disposition of property by the nuclear decommissioning fund for purposes of section 1001. In determining the amount of gain or loss from such disposition, the amount realized by the nuclear decommissioning fund shall be the fair market value of the property on the date of disposition.

(3) *Denial of credits against tax.* The tax imposed on the modified gross income of a nuclear decommissioning fund under paragraph (a) of this section is not to be reduced or offset by any credits against tax provided by part IV of subchapter A of chapter 1 of the Internal Revenue Code other than the credit provided by section 31(c) for amounts withheld under section 3406 (back-up withholding).

(4) *Other corporate taxes inapplicable.* Although the modified gross income of a nuclear decommissioning fund is subject to tax at a rate equal to the maximum rate in effect under section 11(b) (determined without regard to any rate that is added to the otherwise applicable rate in order to offset the effect of the graduated rate schedule), a nuclear decommissioning fund is not subject to the other taxes imposed on corporations under subtitle A of the Internal Revenue Code. For example, a nuclear decommissioning fund is not subject to the alternative minimum tax imposed by section 55, the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, and the alternative tax imposed on a corporation under section 1201(a).

(d) *Treatment as corporation for purposes of subtitle F.* For purposes of subtitle F of the Internal Revenue Code and the regulations thereunder, a nuclear decommissioning fund is to be treated as if it were a corporation and the tax imposed by section 468A(e)(2) and paragraph (a) of this section is to be treated as tax imposed by section 11. Thus, for example, the following rules apply:

(1) A nuclear decommissioning fund must file a return with respect to the tax imposed by section 468A(e)(2) and paragraph (a) of this section of each taxable year (or portion thereof) that the fund is in existence even though no amount is included in the gross income of the fund for such taxable year. The return is to be made on Form 1120-ND in accordance with the instructions relating to such form. For purposes of this paragraph (d)(1), a nuclear decommissioning fund is in existence for the period that—

(i) Begins on the date that the first deductible payment is actually made to such nuclear decommissioning fund; and

(ii) Ends on the date of termination (see paragraph (d) of §1.468A-5), the date that the entire fund is disqualified (see paragraph (c) of §1.468A-5), or the date that the electing taxpayer disposes of its entire qualifying interest in the nuclear power plant to which the nuclear decommissioning fund relates (see §1.468A-6), whichever is applicable.

(2) For each taxable year of the nuclear decommissioning fund, the return described in paragraph (d)(1) of this section must be filed on or before the 15th day of the third month following the close of such taxable year unless the nuclear decommissioning fund is granted an extension of time for filing under section 6081. If such an extension is granted for any taxable year, the return for such taxable year must be filed on or before the extended due date for such taxable year. In no event will the filing of the initial return of a nuclear decommissioning fund be required before January 6, 1987.

(3) A nuclear decommissioning fund must provide its employer identification number on returns, statements and other documents as required by the forms and instructions relating thereto. The employer identification number is obtained by filing a Form SS-4 in accor-

dance with the instructions relating thereto.

(4) A nuclear decommissioning fund must make payments of estimated tax during its taxable year as provided in section 6154(b) if its estimated tax for such taxable year can reasonably be expected to be $40 or more. For purposes of section 6154 and this section, the estimated tax of a nuclear decommissioning fund for any taxable year is the amount that the nuclear decommissioning fund estimates as the amount of tax imposed by section 468A(e)(2) and paragraph (a) of this section for such taxable year.

(5) A nuclear decommissioning fund must deposit all payments of tax imposed by section 468A(e)(2) and paragraph (a) of this section (including any payments of estimated tax) with an authorized government depositary in accordance with §1.6302-1.

(6) A nuclear decommissioning fund is subject to the addition to tax imposed by section 6655 in case of a failure to pay estimated income tax. For purposes of section 6655 and this section—

(i) The tax with respect to which the amount of the underpayment is computed in the case of a nuclear decommissioning fund is the tax imposed by section 468A(e)(2) and paragraph (a) of this section; and

(ii) A nuclear decommissioning fund is to be considered a large corporation under section 6655(i) if such nuclear decommissioning fund had modified gross income (as defined in paragraph (b) of this section) of $1,000,000 or more for any taxable year during the testing period.

§1.468A-5 Nuclear decommissioning fund qualification requirements; prohibitions against self-dealing; disqualification of nuclear decommissioning fund; termination of fund upon substantial completion of decommissioning.

(a) *Qualification requirements*—(1) *In general.* (i) A nuclear decommissioning fund must be established and maintained at all times in the United States pursuant to an arrangement that qualifies as a trust under State law. Such trust must be established for the exclusive purpose of providing funds for the decommissioning of one or more nuclear power plants, but a single trust agreement may establish multiple funds for such purpose, Thus—

(A) Two or more nuclear decommissioning funds can be established and maintained pursuant to a single trust agreement; and

(B) One of more funds that are to be used for the decommissioning of a nuclear power plant and that do not qualify as nuclear decommissioning funds under this paragraph (a) (nonqualified decommissioning funds) can be established and maintained pursuant to a trust agreement that governs one or more nuclear decommissioning funds.

(ii) A separate nuclear decommissioning fund is required for each electing taxpayer and for each nuclear power plant with respect to which an electing taxpayer possesses a qualifying interest. The Internal Revenue Service shall issue a separate schedule of ruling amounts with respect to each nuclear decommissioning fund and each nuclear decommissioning fund must file a separate income tax return even if other nuclear decommissioning funds or nonqualified decommissioning funds are established and maintained pursuant to the trust agreement governing such fund or the assets of other nuclear decommissioning funds or nonqualified decommissioning funds are pooled with the assets of such fund.

(iii) The assets of two or more nuclear decommissioning funds (whether or not established pursuant to a single trust agreement) can be pooled for the purpose of investing the assets in property described in paragraph (a)(3)(i)(C) of this section if and only if—

(A) The trustee of each nuclear decommissioning fund separately accounts for the contributions, earnings, expenses, and distributions of such fund;

(B) The earnings and expenses are reasonably apportioned among such nuclear decommissioning funds; and

(C) The books and records of such funds enable the Internal Revenue Service to verify that the requirements of section 468A and §§1.468A-1 through 1.468A-8 are satisfied with respect to each nuclear decommissioning fund.

(iv) The assets of nonqualified decommissioning funds can be pooled with the assets of one or more nuclear decommissioning funds for the purpose of investing the assets in property described in paragraph (a)(3)(i)(C) of this section if and only if the requirements of paragraph (a)(1)(iii)(A) and (C) of this section are satisfied and earnings and expenses are reasonably apportioned among the pooled funds.

(v) An electing taxpayer can maintain only one nuclear decommissioning fund for each nuclear power plant with respect to which the taxpayer elects the application of section 468A. If a nuclear power plant is subject to the ratemaking jurisdiction of two or more public utility commissions and any such public utility commission requires a separate fund to be maintained for the benefit of ratepayers whose rates are established or approved by the public utility commission, the separate funds maintained for such plant (whether or not established and maintained pursuant to a single trust agreement) shall be considered a single nuclear decommissioning fund for purposes of section 468A and §§1.468A-1 through 1.468A-8. Thus, for example, the Internal Revenue Service shall issue one schedule of ruling amounts with respect to such nuclear power plant (see paragraph (f) of §1.468A-3), the nuclear decommissioning fund must file a single income tax return (see paragraph (d)(1) of §1.468A-4), and, if the Internal Revenue Service disqualifies the nuclear decommissioning fund, the assets of each separate fund are treated as distributed on the date of disqualification (see paragraph (c)(3) of this section).

(2) *Limitation on contributions.* Except as otherwise provided in paragraph (b)(2)(ii) of §1.468A-8 (relating to a special transitional rule), a nuclear decommissioning fund is not permitted to accept any contributions in cash or property other than cash payments with respect to which a deduction is allowed under section 468A(a) and paragraph (a) of §1.468A-2. Thus,

for example, unless the exception contained in paragraph (b)(2)(ii) of §1.468A-8 applies, securities may not be contributed to a nuclear decommissioning fund even if the taxpayer or a fund established by the taxpayer previously held such securities for the purpose of providing funds for the decommissioning of a nuclear power plant.

(3) *Limitation on use of fund*—(i) *In general.* The assets of a nuclear decommissioning fund are to be used exclusively—

(A) To satisfy, in whole or in part, the liability of the electing taxpayer for decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates;

(B) To pay administrative costs and other incidental expenses of the nuclear decommissioning fund; and

(C) To the extent that the assets of the nuclear decommissioning fund are not currently required for the purposes described in paragraph (a)(3)(i)(A) or (B) of this section, to invest directly in—

(*1*) Public debt securities of the United States;

(*2*) Obligations of a State or local government that are not in default as to principal or interest; or

(*3*) Time or demand deposits in a bank (as defined in section 581) or an insured credit union (within the meaning of section 101(6) of the Federal Credit Union Act, 12 U.S.C. 1752 (7) (1982), located in the United States.

(ii) *Terms defined.* The following terms are defined for purposes of paragraph (a)(3)(i) of this section:

(A) The term "administrative costs and other incidental expenses of a nuclear decommissioning fund" means all ordinary and necessary expenses incurred in connection with the operation of the nuclear decommissioning fund. Such term includes the tax imposed by section 468A(e)(2) and paragraph (a) of §1.468A-4, any State or local tax imposed on the income or the assets of the fund, legal expenses, accounting expenses, acturial expenses and trustee expenses. Such term does not include decommissioning costs. Such term also does not include the excise tax imposed on the trustee or other disqualified person under section 4951 or the reimbursement of any expenses incurred in connection with the assertion of such tax unless such expenses are considered reasonable and necessary under section 4951(d)(2)(C) and it is determined that the trustee or other disqualified person is not liable for the excise tax.

(B) The term "public debt securities of the United States" means obligations that are taken into consideration for purposes of the public debt limit.

(C) The term "obligations of a State or local government" means obligations of a State or local governmental unit the interest on which is exempt from tax under section 103(a).

(D) The term "time or demand deposits" includes checking accounts, savings accounts, certificates of deposit or other time or demand deposits. The term does not include common or collective trust funds, such as a common trust fund as defined in section 584.

(b) *Prohibitions against self-dealing*—(1) *In general.* Except as otherwise provided in this paragraph (b), the excise taxes imposed by section 4951 shall apply to each act of self-dealing between a disqualified person and a nuclear decommissioning fund.

(2) *Self-dealing defined.* For purposes of this paragraph (b), the term "self-dealing" means any act described in section 4951(d), except—

(i) A payment by a nuclear decommissioning fund for the purpose of satisfying, in whole or in part, the liability of the electing taxpayer for decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates;

(ii) A withdrawal of an excess contribution by the electing taxpayer pursuant to the rules of paragraph (c)(2) of this section;

(iii) A withdrawal by the electing taxpayer of amounts that have been treated as distributed under paragraph (c)(3) of this section;

(iv) A payment of amounts remaining in a nuclear decommissioning fund to the electing taxpayer after the termination of such fund (as determined under paragraph (d) of this section);

(v) Any act described in section 4951(d)(2)(B) or (C); or

(vi) A payment by a nuclear decommissioning fund for the performance of trust functions and certain general banking services by a bank or trust company which is a disqualified person, where the banking services are reasonable and necessary to carry out the purposes of the fund, if the compensation paid to the bank or trust company, taking into account the fair interest rate for the use of the funds by the bank or trust company, for such services is not excessive. The general banking services allowed by this paragraph (b)(2)(vi) are—

(A) Checking accounts, as long as the bank does not charge interest on any overwithdrawals,

(B) Savings accounts, as long as the fund may withdraw its funds on no more than 30 days notice without subjecting itself to a loss of interest on its money for the time during which the money was on deposit, and

(C) Safekeeping activities. (See example 3 of §53.4941(d)-3(c)(2)).

(3) *Disqualified person defined.* For purposes of this paragraph (b), the term "disqualified person" includes each person described in section 4951(e)(4) and paragraph (d) of §53.4951-1.

(c) *Disqualification of nuclear decommissioning fund*—(1) *In general.* Except as otherwise provided in paragraph (c)(2) of this section, if at any time during a taxable year of a nuclear decommissioning fund—

(i) The nuclear decommissioning fund does not satisfy the requirements of paragraph (a) of this section, or

(ii) The nuclear decommissioning fund and a disqualified person engage in an act of self-dealing (as defined in paragraph (b)(2) of this section),

the Internal Revenue Service may, in its discretion, disqualify all or any portion of the fund as of the date that the fund does not satisfy the requirements of paragraph (a) of this section or the date on which the act of self-dealing occurs.

whichever is applicable, or as of any subsequent date ("date of disqualification"). The Internal Revenue Service shall notify the electing taxpayer of the disqualification of a nuclear decommissioning fund and the date of disqualification by registered or certified mail to the last known address of the electing taxpayer (the "notice of disqualification").

(2) *Exception to disqualification*—(i) *In general.* A nuclear decommissioning fund will not be disqualified under paragraph (c)(1) of this section by reason of an excess contribution or the withdrawal of such excess contribution by an electing taxpayer if the amount of the excess contribution is withdrawn by the electing taxpayer on or before the date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for the taxable year to which the excess contribution relates. In the case of an excess contribution that is the result of a payment made pursuant to paragraph (j)(1) of §1.468A-3, a nuclear decommissioning fund will not be disqualified under paragraph (c)(1) of this section if the amount of the excess contribution is withdrawn by the electing taxpayer on or before the later of—

(A) The date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for the taxable year to which the excess contribution relates; or

(B) The date that is 30 days after the date that the taxpayer receives the ruling amount for such taxable year.

(ii) *Excess contribution defined.* For purposes of this section, an excess contribution is the amount by which cash payments made (or deemed made) to a nuclear decommissioning fund during any taxable year exceed the payment limitation contained in section 468A(b) and paragraph (b) of §1.468A-2.

(iii) *Taxation of income attributable to an excess contribution.* The income of a nuclear decommissioning fund attributable to an excess contribution is required to be included in the gross income of the nuclear decommissioning fund under paragraph (b) of §1.468A-4.

(3) *Effect of disqualification.* If all or any portion of a nuclear decommissioning fund is disqualified under paragraph (c)(1) of this section, the portion of the nuclear decommissioning fund that is disqualified is treated as distributed to the electing taxpayer on the date of disqualification. Such a distribution shall be treated for purposes of section 1001 as a disposition of property held by the nuclear decommissioning fund (see paragraph (c)(2) of §1.468A-4). In addition, the electing taxpayer must include in gross income for the taxable year that includes the date of disqualification an amount equal to the product of—

(i) The fair market value of the assets of the fund determined as of the date of disqualification, reduced by—

(A) The amount of any excess contribution that was not withdrawn before the date of disqualification if no deduction was allowed with respect to such excess contribution;

(B) The amount of any deemed distribution that was not actually distributed before the date of disqualification (as determined under paragraph (d)(2)(iii) of §1.468A-2) if the amount of the deemed distribution was included in the gross income of the electing taxpayer for the taxable year in which the deemed distribution occurred; and

(C) The amount of any tax that—

(*1*) Is imposed on the income of the fund;

(*2*) Is attributable to income taken into account before the date of disqualification or as a result of the disqualification; and

(*3*) Has not been paid as of the date of disqualification; and

(ii) The fraction of the nuclear decommissioning fund that was disqualified under paragraph (c)(1) of this section.

Contributions made to a disqualified fund after the date of disqualification are not deductible under section 468A(a) and paragraph (a) of §1.468A-2, or, if the fund is disqualified only in part, are deductible only to the extent provided in the notice of disqualification. In addition, if any assets of the fund that are deemed distributed under this paragraph (c)(3) are held by the fund after the date of disqualification (or if additional assets are acquired with nondeductible contributions made to the fund after the date of disqualification), the income earned by such assets after the date of disqualification must be included in the gross income of the electing taxpayer (see section 671) to the extent that such income is otherwise includible under chapter 1 of the Internal Revenue Code. An electing taxpayer can establish a nuclear decommissioning fund to replace a fund that has been disqualified in its entirety only if the Internal Revenue Service specifically consents to the establishment of a replacement fund in connection with the issuance of an initial schedule of ruling amounts for such replacement fund.

(d) *Termination of nuclear decommissioning fund upon substantial completion of decommissioning*—(1) *In general.* Upon substantial completion of the decommissioning of a nuclear power plant to which a nuclear decommissioning fund relates, such nuclear decommissioning fund shall be considered terminated and treated as having distributed all of its assets on the date the termination occurs. Such a distribution shall be treated for purposes of section 1001 as a disposition of property held by the nuclear decommissioning fund (see paragraph (c)(2) of §1.468A-4). In addition, the electing taxpayer shall include in gross income for the taxable year in which the termination occurs an amount equal to the fair market value of the assets of the fund determined as of the date of termination, reduced by—

(i) The amount of any deemed distribution that was not actually distributed before the date of termination if the amount of the deemed distribution was included in the gross income of the electing taxpayer for the taxable year in which the deemed distribution occurred; and

(ii) The amount of any tax that—

(A) Is imposed on the income of the fund;

(B) Is attributable to income taken into account before the date the termination occurs or as a result of the termination; and

(C) Has not been paid as of the date the termination occurs.

Contributions made to a nuclear decommissioning fund after the termination date are not deductible under section 468A(a) and paragraph (a) of §1.468A-2. In addition, if any assets are held by the fund after the termination date, the income earned by such assets after the termination date must be included in the gross income of the electing taxpayer (see section 671) to the extent that such income is otherwise includible under chapter 1 of the Internal Revenue Code. Finally, an electing taxpayer using an accrual method of accounting is allowed a deduction for nuclear decommissioning costs that are incurred during any taxable year (see paragraph (e) of §1.468A-2) even if such costs are incurred after substantial completion of decommissioning (*e.g.*, expenses incurred to monitor or safeguard the plant site).

(2) *Substantial completion of decommissioning defined.* (i) Except as otherwise provided in paragraph (d)(2)(ii) of this section, the substantial completion of the decommissioning of a nuclear power plant occurs on the date that the maximum acceptable radioactivity levels mandated by the Nuclear Regulatory Commission with respect to a decommissioned nuclear power plant are satisfied (the "substantial completion date").

(ii) If a significant portion of the total estimated decommissioning costs with respect to a nuclear power plant are not incurred on or before the substantial completion date, an electing taxpayer may request, and the Internal Revenue Service shall issue, a ruling that designates the date on which substantial completion of decommissioning occurs. The date designated in the ruling shall not be later than the last day of the third taxable year after the taxable year that includes the substantial completion date. The request for a ruling under this paragraph (d)(2)(ii) must be filed during the taxable year that includes the substantial completion date and must comply with the procedural rules in effect at the time of the request.

§1.468A-6 Disposition of an interest in a nuclear power plant. [Reserved.]

§1.468A-7 Manner of and time for making election.

(a) *In general.* An eligible taxpayer is allowed a deduction for the taxable year in which the taxpayer makes a cash payment (or is deemed to make a cash payment) to a nuclear decommissioning fund only if the taxpayer elects the application of section 468A. A separate election is required for each nuclear decommissioning fund and for each taxable year with respect to which payments are to be deducted under section 468A. In the case of an affiliated group of corporations that join in the filing of a consolidated return for a taxable year, the common parent must make a separate election on behalf of each member whose payments to a nuclear decommissioning fund during such taxable year are to be deducted under section 468A. The election under section 468A for any taxable year is irrevocable and must be made by attaching a statement ("Election Statement") and a copy of the schedule of ruling amounts provided pursuant to the rules of §1.468A-3 to the taxpayer's Federal income tax return (or, in the case of an affiliated group of corporations that join in the filing of a consolidated return, the consolidated return) for such taxable year. Except as otherwise provided in paragraph (b)(3) of §1.468A-8, the return to which the Election Statement and a copy of the schedule of ruling amounts is attached must be filed on or before the time prescribed by law (including extensions) for filing the return for the taxable year with respect to which payments are to be deducted under section 468A.

(b) *Required information.* The Election Statement must include the following information:

(1) The legend "Election Under Section 468A" typed or legibly printed at the top of the first page.

(2) The electing taxpayer's name, address and taxpayer identification number (or, in the case of an affiliated group of corporations that join in the filing of a consolidated return, the name, address and taxpayer identification number of each electing taxpayer).

(3) The taxable year for which the election is made.

(4) For each nuclear decommissioning fund for which an election is made—

(i) The name and location of the nuclear power plant to which the fund relates;

(ii) The name and employer identification number of the nuclear decommissioning fund;

(iii) The total amount of actual cash payments made to the nuclear decommissioning fund during the taxable year that were not treated as deemed cash payments under paragraph (c)(1) of §1.468A-2 for a prior taxable year;

(iv) The total amount of cash payments deemed made to the nuclear decommissioning fund under paragraph (c)(1) of §1.468A-2 for the taxable year; and

(v) The cost of service amount for the taxable year (see paragraph (b)(2) of §1.468A-2).

§1.468A-8 Effective date and transitional rules.

(a) *Effective date*—(1) *In general.* Section 468A and §§1.468A-1 through 1.468A-8 are effective on July 18, 1984, and apply with respect to taxable years ending on or after such date.

(2) *Cut-off method applicable to electing taxpayers.* Any amount of nuclear decommissioning costs taken into account before July 18, 1984, for a taxable year beginning before such date, is not allowable as a deduction after July 17, 1984, under section 468A(c)(2) and paragraph (e) of §1.468A-2.

(b) *Transitional rules*—(1) *Time for filing request for schedule of ruling amounts.* The Internal Revenue Service shall provide a ruling amount for any taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, if—

(i) Paragraph (g) of §1.468A-3 is satisfied for the taxable year; and

(ii) The taxpayer files a request for a schedule of ruling amounts that includes a proposed ruling amount for the taxable year on or before June 1, 1988.

(2) *Manner of and time for making contributions to a nuclear decommissioning fund.* (i) The amount of any contribution (including a contribution of property allowed under paragraph (b)(2)(ii) of this section) to a nuclear decommissioning fund that relates to a taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, shall be deemed made during such taxable year if—

(A) The taxpayer makes such contribution on or before the 30th day after the date the taxpayer receives a ruling amount applicable to such taxable year; and

(B) The taxpayer irrevocably designates the amount of such contribution as relating to such taxable year on the Election Statement attached to its Federal income tax return (or amended return) for such taxable year.

(ii) (A) An electing taxpayer may contribute property to a nuclear decommissioning fund if the property—

(*1*) Is described in paragraph (a)(3)(i)(C) of §1.468-5;

(*2*) Was acquired after July 18, 1984, and before March 3, 1988;

(*3*) Is contributed for any taxable year ending after July 18, 1984, and beginning before March 3, 1988.

(B) If a taxpayer contributes property to a nuclear decommissioning fund under this paragraph (b)(2)(ii)

(*1*) The amount of the contribution (and the basis of the property to the nuclear decommissioning fund) shall equal the fair market value of the property on the date the property is contributed to the nuclear decommissioning fund;

(*2*) The contribution of the property to the nuclear decommissioning fund shall be considered a sale or exchange of the property by the taxpayer for purposes of section 1001; and

(*3*) For purposes of section 1001, the amount realized by the taxpayer shall be the fair market value of the property on the date the property was contributed to the nuclear decommissioning fund.

(iii) A fund established by a taxpayer for the purpose of paying the decommissioning costs of a nuclear power plant is not treated as a nuclear decommissioning fund before the earlier of—

(A) The date the taxpayer receives an initial schedule of ruling amounts with respect to the fund, or

(B) The first day of the first taxable year of the taxpayer that begins on or after January 1, 1987,

even if the taxpayer elects the application of section 468A for a taxable year that begins before such date. Any income earned before such date by the assets of a fund that satisfies the requirements of §1.468A-5 must be included in the gross income of the taxpayer treated under section 671 as the owner of such assets.

(iv) If a fund is first treated as a nuclear decommissioning fund on the date described in paragraph (b)(2)(iii) of this section—

(A) The assets held in the fund on such date shall be treated for purposes of this paragraph (b)(2) as assets contributed to the nuclear decommissioning fund on such date; and

(B) The withdrawal of any such assets on or before the date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for the taxable year that includes such date shall be treated in the same manner as the withdrawal of an excess contribution (see paragraph (c)(2) of §1.468A-5).

(3) *Manner of and time for making election.* A taxpayer may elect the application of section 468A for a taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, by attaching the Election Statement and a copy of the schedule of ruling amounts to—

(i) A return that is filed on or before the time prescribed by law (including extensions) for filing to return for such taxable year; or

(ii) An amended return for such taxable year that is filed on or before the 90th day after the date that the taxpayer receives a ruling amount for such taxable year.

(4) *Determination of cost of service limitation.* (i) For purposes of section 468A(b)(1) and paragraph (b)(2)(ii) of §1.468A-2, decommissioning costs included in cost of service for any taxable year beginning before January 1, 1987, shall include decommissioning costs that can be accurately determined from information contained in the regulated books of account or other written records of the taxpayer.

(ii) For purposes of section 468A(b)(1) and paragraph (b)(2) of §1.468A-2, the cost of service amount applicable to a nuclear decommissioning fund for the taxable year that includes July 18, 1984, is the amount determined under paragraph (b)(2) of §1.468A-2 multiplied by a fraction, the numerator of which is the amount of nuclear decommissioning costs that is directly or indirectly charged to customers in such taxable year and that is included in the taxable income of the taxpayer for such taxable year and the denominator of which is the amount of nuclear decommissioning costs that is directly or indirectly charged to customers in such taxable year and that would have been included in the gross income of the taxpayer if such costs were taken into account by the taxpayer in the same manner as amounts charged for electric energy (see §1.88-1). Under the preceding sentence, an amount of decommissioning costs is included in the taxable income of a taxpayer for the taxable year that includes July 18, 1984, if the amount is included in gross income for such taxable year and no deduction (other than a deduction allowed under section 468A (a) and paragraph (a) of §1.468A-2) is claimed with respect to such amount for such taxable year.

(5) *Assumptions and determinations to be used in determining ruling amounts.* (i) To the extent consistent with the principles and provisions of §1.468A-3, a ruling amount for any taxable year beginning before January 1, 1987, shall be based on the reasonable assumptions and determinations used by the applicable public utility commission(s) in establishing or approving the amount of decommissioning costs included in cost of service for ratemaking purposes for such taxable year.

(ii) If the applicable public utility commission(s) did not disclose the after-tax rate of return used in establishing or approving the amount of decommissioning costs included in cost of service for any period during a taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, the after-tax rate of return during such period is equal to 54 percent of the overpayment rate in effect under section 6621 during such period.

(iii) If the applicable public utility commission(s) did not disclose the other assumptions and determinations used in establishing or approving the amount of decommissioning costs included in cost of service for any taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, a ruling amount for each such taxable year shall be determined by taking into account—

(A) The amount of decommissioning costs included in cost of service for such taxable year;

(B) The qualifying percentage (as determined under paragraph (d)(4) of §1.468A-3 and paragraph (b)(7) of this section); and

(C) The amount of decommissioning costs included in cost of service for any earlier taxable year.

(6) *Exception to level funding limitation.* Notwithstanding paragraph (b) of §1.468A-3, the Internal Revenue Service may, in its discretion, provide a schedule of ruling amounts for a taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, that is greater than the ruling amount specified in such schedule for a later taxable year.

(7) *Determination of qualifying percentage.* (i) (A) The qualifying percentage shall be determined under this paragraph (b)(7)(i) if a nuclear power plant began commercial operations on or before July 10, 1986, and a taxpayer—

(*1*) Files a request for a schedule of ruling amounts for the nuclear decommissioning fund maintained with respect to such nuclear power plant on or before June 1, 1988; and

(*2*) Elects the application of this paragraph (b)(7)(i) in its request for a schedule of ruling amounts.

(B) If the qualifying percentage is determined under this paragraph (b)(7)(i), the estimated period for which the nuclear decommissioning fund is to be in effect for purposes of paragraph (d)(4)(ii) of §1.468A-3 begins on the later of—

(*1*) The first day of the taxable year that includes the date that the nuclear power plant began commercial operations; or

(*2*) The first day of the taxable year that includes July 18, 1984.

(ii) (A) The qualifying percentage shall be determined under this paragraph (b)(7)(ii) if a nuclear power plant began commercial operations before July 18, 1984, and a taxpayer—

(*1*) Files a request for a schedule of ruling amounts for the nuclear decommissioning fund maintained with respect to such nuclear power plant on or before June 1, 1988; and

(*2*) Elects the application of this paragraph (b)(7)(ii) in its request for a schedule of ruling amounts.

(B) If the qualifying percentage is determined under this paragraph (b)(7)(ii), the estimated period for which the nuclear decommissioning fund is to be in effect for purposes of paragraph (d)(4)(ii) of §1.468A-3 and the estimated useful life of the nuclear power plant for purposes of paragraph (d)(4)(iii) of §1.468A-3 shall end on the earlier of—

(*1*) the last day of the taxable year in which it is estimated that decommissioning will begin; or

(*2*) the last day of the taxable year that includes the expiration date of the Nuclear Regulatory Commission operating license as in effect on July 18, 1984, without regard to any extensions or amendments thereto.

(iii) In the case of a nuclear power plant that began commercial operations before July 18, 1984, and whose estimated useful life for ratemaking purposes was adjusted by a public utility commission before July 18, 1984, a taxpayer may elect in its request for a schedule of ruling amounts to compute the qualifying percentage in accordance with the following rules:

(A) If the taxpayer files a request for a schedule of ruling amounts for the nuclear decommissioning fund maintained with respect to such nuclear power plant on or before June 1, 1988, the qualifying percentage equals the percentage of original depreciation costs (determined without regard to capitalized decommissioning costs) with respect to the nuclear power plant that remains to be recovered for ratemaking purposes as of the first day of the taxable year that includes July 18, 1984.

(B) If a taxpayer does not file a request for a schedule of ruling amounts for the nuclear decommissioning fund maintained with respect to such nuclear power plant on or before June 1, 1988, the qualifying percentage equals the percentage of original depreciation costs (determined without regard to capitalized decommissioning costs) with respect to the nuclear power plant that remains to be recovered for ratemaking purposes as of the first day of the first taxable year for which a deductible payment is made to the nuclear decommissioning fund that relates to such nuclear power plant.

(C) For purposes of this paragraph (b)(7)(iii), original depreciation costs with respect to a nuclear power plant include only those costs that were taken into account in determining the amount of depreciation with respect to such plant in the first ratemaking proceeding in which such depreciation was treated as a cost of service.

(8) *Limitation on payments to a nuclear decommissioning fund*—(i) The limitation on payments to a nuclear decommissioning fund (see section 468A(b) and paragraph (b) of §1.468A-2) for a taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, shall be determined under paragraph (b)(8)(ii) of this section if—

(A) The electing taxpayer receives a ruling amount applicable to such taxable year after the deemed payment deadline date for such taxable year; and

(B) The requirements of paragraph (b)(8)(iii) of this section are satisfied.

(ii) If the limitation on payments to a nuclear decommissioning fund for a taxable year is determined under this paragraph (b)(8)(ii), the maximum amount of payments made (or deemed made) to the nuclear decommissioning fund during such taxable year shall not exceed the sum of—

(A) The amount determined under section 468A(b) and paragraph (b) of §1.468A-2 (*i.e.*, the lesser of the cost of service amount or the ruling amount) after application of the transitional rules contained in paragraph (b)(4), (5), (6) and (7) of this section; and

(B) The amount of after-tax earnings that would have accumulated to the date of actual payment to the nuclear decommissioning fund if the amount described in paragraph (b)(8)(ii)(A) of this section had been contributed to the nuclear decommissioning fund on the deemed payment deadline date for such taxable year.

In determining the after-tax earnings that would have accumulated to the date of payment, an electing taxpayer must use the after-tax rate of return of the nuclear decommissioning fund that was used in determining the initial schedule of ruling amounts.

(iii) In order to compute the payment limitation under paragraph (b)(8)(ii) of this section for any taxable year, an electing taxpayer must—

(A) Indicate on the Election Statement for the taxable year that the amount of the deductible payment is greater than the amount determined under section 468A(b) and paragraph (b) of §1.468A-2 because paragraph (b)(8) of §1.468A-8 applies;

(B) Not have claimed a deduction for the taxable year under section 468A(a) or paragraph (a) of §1.468A-2 on any return that is filed before the date that a ruling amount is received for the taxable year;

(C) Not have taken a deduction under section 468A(a) or paragraph (a) of §1.468A-2 into account in determining the amount properly estimated as tax for the taxable year under section 6081(b) (relating to the automatic extension for filing corporate income tax returns); and

(D) Not take the deduction allowed with respect to such payment into account in determining the amount of any overpayment of tax (within the meaning of section 6611) or underpayment of tax (within the meaning of section 6601) for the period ending on the date of such payment (see paragraph (b)(9) of this section.

(iv) The following example illustrates the application of the principles of paragraph (b)(8) of this section:

Example. X corporation is a calendar year, accrual method taxpayer engaged in the sale of electric energy generated by a nuclear power plant owned by X. On September 15, 1987, X receives a schedule of ruling amounts from the Internal Revenue Service that includes a ruling amount of $1,000,000 for the 1986 taxable year. For purposes of this example, assume that the cost of service amount applicable to the nuclear decommissioning fund for the 1986 taxable year is also $1,000,000 and that the after-tax rate of return of the nuclear decommissioning fund that was used in determining the schedule of ruling amounts is 10 percent compounded semi-annually. On September 15, 1987, X makes a contribution of $1,050,000 to a nuclear decommissioning fund established by X. Under paragraph (b)(8)(ii) of this section, this contribution does not exceed the limitation on payments for the 1986 taxable year and the entire amount of the contribution is deductible for such year. The additional $50,000 deductible payment that is allowed under this paragraph (b)(8) reflects the foregone earnings of the fund for the six-month period beginning on the deemed payment deadline date for the 1986 taxable year (March 15, 1987) and ending on the date of the contribution (September 15, 1987).

(9) *Denial of interest on overpayment.* If a deduction is allowed by reason of paragraph (b)(2) of this section for the amount of any payment made after the 15th day of the third calendar month after the close of the taxable year to which such payment relates, such deduction shall not be taken into account in determining the amount of any overpayment of tax (within the meaning of section 6611) or underpayment of tax (within the meaning of section 6601) for the period ending on the date of such payment.

(10) *Determination of addition to tax for failure to pay estimated tax.* In the case of any taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, the tax shown on the return for such taxable year for purposes of section 6655(b) shall equal the tax that would be shown on the return if a deduction were allowed for the lesser of—

(i) The amount of the payment made to the nuclear decommissioning fund for such taxable year; or

(ii) The amount determined under section 468A(b) and paragraph (b) of §1.468A-2 (*i.e.*, the lesser of the cost of service amount or the ruling amount) after application of the transitional rules contained in paragraph (b)(4), (5), (6) and (7) of this section but without regard to the transitional rule contained in paragraph (b)(8) of this section.

OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

(26 CFR Part 602)

Par. 6. The authority citation for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 7. Section 602.101 (c) is amended by inserting in the appropriate place in the table "§1.468A-3 . . . 1545-0954", "§1.468A-4 . . . 1545-0954", "§1.468A-7 . . . 1545-0954", and "§1.468A-8 . . . 1545-0954".

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved February 24, 1988.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on February 29, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 3, 1988, 53 F.R. 6800)

Part III.—Items Specifically Excluded From Gross Income

Section 103.—Interest on State and Local Bonds

26 CFR 1.103-1: Interest upon obligations of a State, Territory, etc.

Section 4.01, paragraphs 4 and 7, of Rev. Proc. 88-3, page 579, this Bulletin, relating to areas under sections 103 and 148 of the Code for which rulings will not ordinarily be issued by the Internal Revenue Service, is modified to reflect changes resulting from the enactment of the Tax Reform Act of 1986, 1986-2 (Vol. 1) C.B. 519. See Rev. Proc. 88-26, page 804.

26 CFR 1.103-1: Interest upon obligations of a State, Territory, etc.

The average area purchase price safe harbor limitations for new and existing single-family residences for the State of Iowa, as published in Rev. Proc. 87-20, 1987-1 C.B. 713, are corrected. See Rev. Proc. 88-30, page 831.

26 CFR 1.103-1: Interest upon obligations of a State, Territory, etc.

Rev. Proc. 81-30, 1981-2 C.B. 554, is amplified and superseded to set forth procedures for requesting approval of a state designation of a geographic area as an "area of chronic economic distress." See Rev. Proc. 88-31, page 832.

26 CFR 1.103-1: Interest upon obligations of a State, Territory, etc.

Rev. Proc. 84-48, 1984-1 C.B. 547, is superseded to update the procedures for the submission of requests for rulings to the Service under sections 103 and 7478 of the Code. See Rev. Proc. 88-32, page 833.

26 CFR 1.103-1: Interest upon obligations of a State, Territory, etc.

Rev. Proc. 84-49, 1984-1 C.B. 548, is superseded and Rev. Proc. 84-50, 1984-1 C.B. 550, is amplified and superseded to update the procedures for the submission of requests for rulings to the Service under section 103 of the Code when the issuer is other than the issuer of the prospective obligation or when the request relates to an outstanding issue of obligations. See Rev. Proc. 88-33, page 835.

26 CFR 1.103-8: Interest on bonds to finance certain exempt facilities.
(Also Section 142.)

Mass commuting vehicles; mass commuting facilities. Mass commuting vehicles are not included within the term "mass commuting facilities" for purposes of former section 103(b)(4)(D) or current section 142(a)(3) of the Code. Rev. Rul. 76-11 clarified.

Rev. Rul. 88-51

ISSUE

Are mass commuting vehicles included in the term "mass commuting facilities" for purposes of former section 103(b)(4)(D) or current section 142(a)(3) of the Internal Revenue Code?

LAW AND ANALYSIS

Section 1301 of the Tax Reform Act of 1986 (1986 Act), 1986-3 (Vol. 1) C.B. 519-75, reorganized and amended the Code provisions governing the tax exemption of interest on obligations of a state or its political subdivisions.

Prior to the 1986 Act, former section 103(a)(1) of the Code provided generally that gross income did not include interest on the obligations of a state or its political subdivisions.

Former section 103(b)(1) of the Code provided, in part, that, except as otherwise provided in section 103(b), any industrial development bond was to be treated as an obligation not described in section 103(a)(1).

Former section 103(b)(4)(D) of the Code provided, in part, that section 103(b)(1) would not apply to industrial development bonds issued as part of an issue substantially all the proceeds of which were to be used to provide "mass commuting facilities."

Rev. Rul. 76-11, 1976-1 C.B. 30, considers whether interest on bonds issued to finance the acquisition and construction of a rapid transit system (monorail) is tax-exempt. In describing the system, the ruling mentions the system vehicles. The ruling concludes that, in determining whether the interest on the bonds is exempt, "the proposed rapid transit system will constitute 'mass commuting facilities' to the extent defined in section 1.103-8(e)(2)(iii) [currently section 1.103-8(e)(2)(iv)] of the Income Tax Regulations."

Section 1.103-8(e)(2)(iv) of the Income Tax Regulations, issued under former section 103(b)(4)(D) of the Code, provides that a "mass commuting facility" includes real property together with improvements and personal property used therein, such as machinery, equipment and furniture, serving the general public commuting on a day-to-day basis by bus, subway, rail, ferry, or other conveyance that moves over prescribed routes. Under this regulation, such term also includes terminals and facilities that are functionally related and subordinate to the mass commuting facility, such as parking garages, car barns, and repair shops. Use of mass commuting facilities by noncommuters in common with commuters is immaterial. Thus, a terminal leased to a common carrier bus line that serves both commuters and long distance travelers would qualify as an exempt facility.

Former section 103(b)(4)(I) of the Code provided that section 103(b)(1) would not apply to industrial development bonds issued as part of an issue substantially all the proceeds of which were to be used to provide "qualified mass commuting vehicles."

Former section 103(b)(9)(A) of the Code provided that, for purposes of section 103(b)(4)(I), the term "qualified mass commuting vehicle" meant any bus, subway car, rail car, ferry, or similar equipment (i) that was leased to a mass transit system wholly owned by one or more governmental units (or agencies or instrumentalities thereof), and (ii) that was used by such system in providing mass commuting services (or, in the case of a ferry, mass transportation services).

Former section 103(b)(9)(B) of the Code provided that section 103(b)(4)(I) would not apply to any obligation issued after December 31, 1984.

Former section 103(b)(4)(I) of the Code was added by section 811 of the Economic Recovery Tax Act of 1981, 1981-2 C.B. 256, 349, because Congress wanted, for a limited time period (1981-1984), to exempt from federal income tax interest on industrial development bonds used to finance mass commuting vehicles. H.R. Rep. No. 97-201, 97th Cong., 1st Sess. 269-70 (1981), 1981-2 C.B. 352, 404. *See* H.R. Rep. No. 97-215 (Conference Report), 97th Cong., 1st Sess. 269-70 (1981), 1981-2 C.B. 481, 518-19.

Under the 1986 Act, section 103(a) of the Code provides generally that gross income does not include interest on any state or local bond.

Section 103(b)(1) of the Code provides that section 103(a) shall not apply to any private activity bond that is not a qualified bond (within the meaning of section 141).

Section 141(e)(1)(A) of the Code provides that the term "qualified bond" means any private activity bond (as defined in section 141(a)) if such bond is an "exempt facility bond."

Section 142(a)(3) of the Code provides that, for purposes of section 141(e)(1)(A), the term "exempt facility bond" includes any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide "mass commuting facilities."

The Conference Committee Report accompanying the 1986 Act states that under prior law the term mass commuting facilities did not include mass commuting vehicles, and that such term generally would continue to be defined in the same manner as under prior law for purposes of new section 142(a)(3) of the Code. H.R. Rep. No. 99-841 (Conference Report), 99th Cong., 2d Sess. II-702 (1986), 1986-3 (Vol. 4) C.B. 702.

HOLDING

Mass commuting vehicles are not included within the term "mass commuting facilities" for purposes of former section 103(b)(4)(D) or current section 142(a)(3) of the Code.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 76-11 is clarified to remove any inference that the vehicles mentioned in Rev. Rul. 76-11 are included in the term "mass commuting facilities."

Section 117—Qualified Scholarships

26 CFR 1.117-1: Exclusion of amounts received as a scholarship or fellowship grant.

For reduced rates of withholding tax on scholarships or grants received by nonresident alien students or grantees. See Rev. Proc. 88-24, page 800.

Section 121.—One-time Exclusion of Gain from Sale of Principal Residence by Individual who has Attained Age 55

26 CFR 1.121-3: Definitions.

Exclusion of gain from sale of principal residence. A gain realized from the relinquishment of rights in a rent-controlled apartment cannot be excluded from gross income under section 121 of the Code.

Rev. Rul. 88-29

ISSUE

Under section 121 of the Internal Revenue Code, may an individual elect to exclude from gross income the gain realized from the relinquishment of rights with respect to a rent-controlled apartment subject to the New York City Rent and Rehabilitation Law?

FACTS

A, age 60, has resided for 25 years in an apartment unit the lease of which is governed by the provisions of the New York City Rent and Rehabilitation Law, sections 26-401 through 26-415, N.Y. Unconsol. Laws (McKinney Supp. 1986). Provided the tenant continues to pay rent, this law prohibits the eviction of a rent-controlled tenant, except on limited grounds. During 1987, *A* realized a gain upon receiving a payment from the owner of the apartment building to relinquish all rights *A* had under this law with respect to the unit.

LAW AND ANALYSIS

Section 121(a) of the Code allows a taxpayer to elect to exclude gain from the sale or exchange of property from gross income if (1) the taxpayer has attained age 55 before the date of the sale or exchange, and (2) during the 5-year period ending on the date of the sale or exchange, the property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 3 years or more. Under section 121(b), the amount of gain excluded from gross income may not exceed $125,000.

Section 1.121-3(a) of the Income Tax Regulations states that the term "principal residence" has the same meaning as in section 1034 of the Code (relating to sale or exchange of residence).

In Rev. Rul. 84-43, 1984-1 C.B. 27, *B* owned a life estate in a residence that *B* had used as a principal residence for 10 years. The life estate was *B*'s entire interest in the residence. Rev. Rul. 84-43 concludes that *B* may elect under section 121 of the Code to exclude from gross income up to $125,000 of the gain from the sale of the life estate. Rev. Rul. 84-43 states that the section 121 is to apply if an elderly taxpayer disposes of the taxpayer's entire interest (legal and equitable) in a principal residence. It is not necessary that the taxpayer own the entire fee interest in such residence.

Rev. Rul. 72-266, 1972-1 C.B. 227, concludes that the present value of future lease payments of 50 years' duration cannot be included in the purchase price of a new principal residence, as the lease payments were to be directed at property in which the taxpayer would not acquire any equity. Therefore, the nonrecognition provisions of section 1034 of the Code did not apply.

Rev. Rul. 72-266 was cited with approval in *Boesel v. Commissioner*, 65 T.C. 378 (1975), a case involving taxpayers who sold their old residence in Connecticut and one week later purchased a new residence in California that was constructed on land originally leased to the seller for 75 years. The taxpayers assumed the ground lease for its remaining 73-year term and attempted to capitalize the value of the future payments under the lease for purposes of calculating the gain to be currently recognized under section 1034 of the Code. The court rejected the taxpayers' interpretation of the law and stated that nonrecognition of gain under section 1034 may be permitted only to the extent that a taxpayer holds fee simple title (or equivalent forms of ownership) to property that is occupied as a principal residence.

Although the New York City Rent and Rehabilitation Law gives tenants substantial possessory rights by restricting the ability of a landlord to evict a rent-controlled tenant, a tenant may be evicted on a variety of grounds, largely concerning the tenant's wrongful conduct within the apartment unit. *See* section 26-408(a), NY Unconsolidated Laws. In addition, the landlord may obtain a certificate of eviction from the New York City rent agency if the landlord requires the apartment for personal use, if the tenant does not actually live in the unit, or if the landlord intends to substantially alter, remodel, or demolish the unit. Moreover, the statute does not give rent-controlled tenants all the rights and privileges of ownership, such as the right to freely sublet the property and the right to transfer the property by gift or sale. The statutory restrictions on *A*'s ability to use, occupy, and transfer the rent-controlled apartment confirm that *A*'s interest is that of a lessee and not an owner.

As *Boesel* Rev. Rul. 72-266 indicate, a lease interest cannot qualify as an ownership interest in a principal residence for purposes of section 1034 of the Code, and an ownership interest is required to qualify for nonrecognition of gain under section 1034. Similarly, a lease interest does not qualify for the section 121 exclusion. Rev. Rul. 84-43 is distinguishable because a life estate is an ownership interest.

HOLDING

A may not elect under section 121 of the Code to exclude from gross income any gain realized from the relinquishment of *A*'s statutory rights in the rent-controlled apartment.

Part IV.—Tax Exemption Requirements for State and Local Bonds

Subpart A.—Private Activity Bonds

Section 142.—Exempt Facility Bond

Whether mass commuting vehicles are included in the term "mass commuting facilities" for purposes of former section 103(b)(4)(D) or current section 142(a)(3) of the Code. See Rev. Rul. 88-51, page 74.

Section 143.—Mortgage Revenue Bonds: Qualified Mortgage Bond and Qualified Veterans' Mortgage Bond

26 CFR 6a.103A-2: Qualified mortgage bond.

The average area purchase price safe harbor limitations for new and existing single-family residences for the State of Iowa, as published in Rev. Proc. 87-20, 1987-1 C.B. 713, are corrected. See Rev. Proc. 88-30, page 831.

---

26 CFR 6a.103A-2: Qualified mortgage bond.

Rev. Proc. 81-30, 1981-2 C.B. 554, is amplified and superseded to set forth procedures for requesting approval of a state designation of a geographic area as an "area of chronic economic distress." See Rev. Proc. 88-31, page 832.

Subpart B.—Requirements Applicable to all State and Local Bonds

---

Section 148.—Arbitrage

26 CFR 1.103-13: Arbitrage bonds.

Section 4.01(7) of Rev. Proc. 88-3, page 579, this Bulletin, relating to an area under section 148 of the Code for which rulings will not ordinarily be issued by the Internal Revenue Service, is modified to reflect changes resulting from the enactment of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 519. See Rev. Proc. 88-26, page 804.

---

26 CFR 1.103-13: Arbitrage bonds.

Rev. Proc. 84-50, 1984-1 C.B. 550, is amplified and superseded to update the procedures for the submission of requests for rulings to the Service under section 148 of the Code when the requester is other than the issuer of the prospective obligation. See Rev. Proc. 88-33, page 835.

Part VI.—Itemized Deductions for Individuals and Corporations

---

Section 162.—Trade or Business Expenses

26 CFR 1.162-1: Business expenses.

The fee paid by a syndicated limited partnership for the tax opinion used in the partnership's prospectus is a syndication expense chargeable by the partnership to a capital account and can not be amortized. See Rev. Rul. 88-4, page 264.

---

26 CFR 1.162-21: Fines and penalties.

Business expenses; fines and penalties. A nonconformance penalty assessed by the Environmental Protection Agency is not a "fine or similar penalty" under section 162(f) of the Code and is, therefore, deductible as a business expense under section 162(a).

Rev. Rul. 88-46

ISSUE

If a taxpayer pays a nonconformance penalty (NCP) assessed by the Environmental Protection Agency (EPA) under section 206(g)(1) of the Clean Air Act (Act), 42 U.S.C. section 7525(g)(1), is that NCP a nondeductible "fine or similar penalty" for purposes of section 162(f) of the Internal Revenue Code?

FACTS

The taxpayer, a manufacturer of heavy-duty trucks and truck engines, has vehicles and engines that fail to conform to certain emission standards imposed under the Act. Section 206(g)(1) of the Act requires the EPA to issue a certificate of conformity for any class or category of heavy-duty vehicles or engines that exceeds a set emission standard but does not exceed an upper limit associated with that standard, if the manufacturer pays an NCP. Manufacturers that sell or introduce into commerce heavy-duty vehicles or engines not covered by certificates of conformity are subject to a civil penalty of not more than $10,000 for each violation of the Act. Because the taxpayer's heavy-duty vehicles and engines did not conform to the established emission standards, the taxpayer paid NCPs so that it could obtain the necessary certificates of conformity for its vehicles and engines.

LAW AND ANALYSIS

Section 162(a) of the Code provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 162(f) of the Code and the regulations thereunder provide that no deduction shall be allowed under section 162(a) for any fine or similar penalty paid to a government for the violation of any law.

Section 1.162-21(b) of the regulations provides, in part, that the term "fine or similar penalty" includes an amount paid as a civil penalty imposed by federal, state, or local law.

Section 206(g)(1) of the Act states that, in the case of any class or category of heavy-duty vehicles or engines to which an emission of air pollutants standard applies, a certificate of conformity shall be issued and shall not be suspended or revoked for such vehicles or engines manufactured by a manufacturer notwithstanding the failure of such vehicles or engines to meet such standard if such manufacturer pays an NCP as provided under regulations promulgated by the EPA Administrator.

Under section 205 of the Act, 42 U.S.C. section 7524, any person who violates the Act by selling or offering for sale any vehicle or vehicle engine that is not covered by a certificate of conformity shall be subject to a civil penalty of not more than $10,000 per truck or engine illegally sold.

Pursuant to the authority under section 206(g)(3) of the Act (See also 40 C.F.R. §86.1113-87 (1986)), the EPA Administrator has promulgated a formula, $NCP = PR \times EE \times AAF$, for calculating each NCP where:

NCP = penalty per vehicle or engine;

PR = penalty rate, which is based on the amount that a conforming manufacturer would likely spend to meet the emission standard, per unit of pollutant;

EE = units of pollutant by which a vehicle or engine exceeds emission standards;

AAF = annual adjustment factor, which increases the penalty based on the inflation rate and the extent of the industry usage of NCPs, to provide an incentive for compliance.

The House Report regarding section 206(g)(3) of the Act states that in order to assure the achievement of the maximum emission reduction that is reasonably projected to be technologically available, while at the same time not ruling the nonconforming manufacturer out of the market, the Committee permitted certain nonconforming vehicles or engines to be certified conditionally upon payment of a nonconforming technology penalty. H.R. Rep. No. 294, 95th Cong., 1st Sess. 275 (1977). Footnote 17 of H.R. Rep. No. 294, at 275, states that this is a performance penalty, irrespective of fault. The report further states that, in connection with adopting these technology-forcing emission standards, the EPA Administrator is required to prescribe an allowable range of nonconformity that will allow any engine or vehicle that fails to meet the revised emission standards, but that nonetheless falls within this range, to be certified and sold provided the NCP is paid. The Conference Report states that the NCPs are to be set at a level that will eliminate the competititve advantage, if any, for the manufacturer of a nonconforming vehicle or engine. H.R. Conf. Rep. No. 564, 95th Cong., 1st Sess. 163 (1977).

The Act and the legislative history indicate that the NCP formula is primarily designed as a permissive and equalizing formula to eliminate the competitive economic advantage that a nonconforming producer might otherwise have over a conforming producer. Congress envisaged an alternative allowable range of nonconformity that would allow a vehicle or engine to be covered by a certificate of conformity upon payment of an NCP. The NCP mechanism grants the EPA permission to conditionally certify nonconformity. This permissive characterization of the NCP mechanism in the legislative history, and the flexibility that mechanism was to provide with respect to Congress' setting of high technological emission standards, are inconsistent with a conclusion that, under section 162(f) of the Code, an NCP is a penalty paid "for the violation of any law." The legislative history of the NCP shows that it is not punitive in nature. Rather, the paying of an NCP provides one of two lawful alternative methods for receiving a certificate of conformity. The other is to simply conform to the established emission standard. Mere nonconformity within the allowable range of nonconformity is not a violation of the Act if there is a payment of the NCP. A taxpayer that pays the NCP and thus receives a certificate of conformity does not fall within section 205 of the Act, which imposes a penalty of not more than $10,000, per vehicle or engine, on manufacturers selling, or introducing into commerce, vehicles or engines not covered by certificates of conformity.

HOLDING

The NCP that was assessed by the EPA is not a "fine or similar penalty" for purposes of section 162(f) of the Code, and, therefore, section 162(f) does not preclude deduction of the NCP as a business expense under section 162(a).

Section 163.—Interest

26 CFR 1.163-5: Denial of interest deduction on certain obligations issued after December 31, 1982, unless issued in registered form.

T.D. 8203

TITLE 26—CHAPTER 1,
SUBCHAPTER A, PART 1—INCOME
TAX TAXABLE YEARS BEGINNING
AFTER DECEMBER 31, 1953

Registration Requirements with Respect to Certain Debt Obligations; Sanctions on Issuers of Registration-Required Obligations Not in Registered Form

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to registration requirements with respect to certain debt obligations and sanctions on issuers of registration required obligations not in registered form. These regulations affect issuers of obligations held by foreign persons and issuers of certain other obligations. These final regulations provide the public with guidance necessary to comply with the Tax Equity and Fiscal Responsibility Act of 1982.

DATE: The regulations under §1.163-5(c)(2)(i) generally apply to obligations issued after December 31, 1982. The regulations under §1.163-5(c)(2)(i)(B) (foreign targeting rules) generally apply to obligations issued after June 20, 1988. The change in §1.163-5(c)(3) to the effective date of §1.163-5T(c)(3) applies with respect to an obligation issued after December 31, 1982 and on or before January 20, 1987.

SUPPLEMENTARY INFORMATION:

BACKGROUND

Section 1.163-5 was issued as T.D. 8110 [1987-1 C.B. 81] and was published in the Federal Register at 51 FR 45453 on December 19, 1986. Section 1.163-5(c)(2)(i) provides, among other things, that an exchange of one obligation for another is considered an original issuance if and only if the exchange constitutes a disposition of property for purposes of section 1001 of the Code. Generally, the assumption of an outstanding obligation by a new obligor constitutes a disposition of property for purposes of section 1001 of the Code, because a change in obligor is a change in a material term of the obligation. Thus, the assumption of an obligation would be considered an original issuance under §1.163-5(c)(2)(i) of the regulations. It has been suggested that compliance with the requirements of §1.163-5(c)(2)(i) imposes a difficult burden upon the assumption of an obligation which was previously in compliance with those requirements if the assumption involves a change in obligor alone with no other changes in the terms of the obligation.

In the preamble to the final regulations under §1.163-5(c), the Treasury Department stated that it does not have the authority to permit the offer, sale, or delivery of bearer obligations inside the United States in connection with their original issuance. Accordingly, the regulations should have required that a bearer obligation be delivered outside the United States in order for the issuer of the obligation to meet the test of arrangements reasonably designed to ensure sale only to persons who are not United States persons. The requirement of delivery outside the United States was not, however, included in the text of §1.163-5(c)(2)(i)(B).

Section 1.163-5(c)(3) requires a certification under §5f.163-1(c)(2)(i)(B)(4) if the taxpayer chooses to apply the rules of §1.163-5(c) with respect to an obligation issued after January 31, 1982 and on or before January 20, 1987. The reference to §5f.163-1(c)(2)(i)(B)(4) is incorrect. The correct citation is §1.163-5T(c)(2)(i)(B)(4).

EXPLANATION OF PROVISIONS

Section 1.163-5(c)(2)(i) of these regulations provides an exception from the general rule that an exchange of one obligation for another is considered an original issuance if and only if the exchange constitutes a disposition of property for purposes of section 1001 of the Code. Under this exception, a change in obligor alone, provided that there are no other changes in the terms of the obligation, will not be considered a new issuance. Accordingly, in such a case an obligation which previously met the requirements of §1.163-5(c)(2)(i) before such a change in obligor, would not have to requalify under §1.163-5(c)(2)(i) after such a change in obligor.

Section 1.163-5(c)(2)(i)(B) provides that a bearer obligation can be delivered only outside the United States under the second test of arrangements reasonably designed to ensure sale (or resale in connection with the original issue) only to a person who is not a United States person. The second test of arrangements reasonably designed applies to an obligation that is registered under the Securities Act of 1933, that is exempt from registration under section 3 or 4 of such Act, or that is not a security.

Section 1.163-5(c)(3) of these regulations requires a certification under §1.163-5T(c)(2)(i)(B)(4) rather than §5f.163-5(c)(2)(i)(B)(4), an incorrect citation.

REGULATORY FLEXIBILITY ACT AND EXECUTIVE ORDER 12291

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive order 12291 and that a regulatory impact analysis therefore is not required. The Internal Revenue Service has concluded that these regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. §553 do not apply. Accordingly, these regulations are not regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

* * * * *

Adoption of amendments to the regulations

The following amendments to 26 CFR Part 1 are hereby adopted:

Paragraph 1. The authority for Part 1 continues to read in part:

Authority: 26 U.S.C. 7805. ***

Par. 2. Section 1.163-5(c)(2)(i) introductory text is amended by adding a new sentence immediately following the second sentence thereof, to read as follows:

* * * * *

However, an exchange of one obligation for another will not be considered a new issuance if the obligation received is identical in all respects to the obligation surrendered in exchange therefor, except that the obligor of the obligation received need not be the same obligor as the obligor of the obligation surrendered.

* * * * *

Par. 3. Section 1.163-5(c)(2)(i)(B)(*4*) is amended by revising the first sentence thereof to read as follows:

> In connection with the original issuance of the obligation in bearer form it is delivered in definitive form (or issued, if the obligation is not in definitive form) to the person entitled to physical delivery thereof only outside the United States and its possessions and only upon presentation of a certificate signed by such person to the issuer, underwriter, or member of the selling group, which certificate states that the obligation is not being acquired by or on behalf of a United States person, or for offer to resell or for resale to a United States person or any person inside the United States, or, if a beneficial interest in the obligation is being acquired by a United States person, that such person is a financial institution as defined in §1.165-12(c)(1)(v) or is acquiring through a financial institution and that the obligation is held by a financial institution that has agreed to comply with the requirements of section 165(j)(3)(A), (B), or (C) and the regulations thereunder and that is not purchasing for offer to resell or for resale inside the United States.

Par. 4. Section 1.163-5(c)(3) is amended by deleting "5f.163-1(c)(2)(i)(B)(4) and inserting in lieu thereof "1.163-5T(c)(2)(i)(B)(*4*)".

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved April 22, 1988.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on May 18, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 19, 1988, 53 F.R. 17926)

---

26 CFR 1.163-5T: Denial of interest deduction on certain obligations issued after December 31, 1982, unless issued in registered form (temporary).
(Also 35a.9999-5.)

T.D. 8202

TITLE 26—INTERNAL REVENUE SERVICE.—SUBCHAPTER A, PART 1—INCOME TAX TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; PART 35A—TEMPORARY EMPLOYMENT TAX REGULATIONS UNDER THE INTEREST AND DIVIDEND TAX COMPLIANCE ACT OF 1983

Registration Requirements with Respect to Certain Debt Obligations; Sanctions on Issuers of Registration-Required Obligations Not in Registered Form

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations and amended temporary regulations.

SUMMARY: This document contains temporary regulations and amendments to temporary regulations relating to registration requirements with respect to certain debt obligations, and sanctions on issuers of registration-required obligations not in registered form. These regulations affect issuers of obligations held by foreign persons and issuers of certain other obligations. These temporary regulations provide the public with guidance necessary to comply with the Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1984. The text of these regulations also serves as the text for a notice of proposed rulemaking published in *** [INTL-990-86, page 916, this Bulletin].

DATE: The temporary regulations under §1.163-5T(d) (pass-through certificates) generally apply to obligations issued after December 31, 1982. The temporary regulations under section 35a.9999-5(f) are deleted effective January 21, 1987.

SUPPLEMENTARY INFORMATION:

BACKGROUND

Section 1.163-5T(d) provides temporary regulations addressing the application of the term "registration-required obligations" to pass-through certificates, such as mortgage pass-through certificates, and the application of the sanctions on issuers of "registration-required obligations" not in registered form to the issuers of such certificates. These temporary regulations were originally published in the Federal Register as T.D. 8046 [1985-2 C.B. 61] at 50 FR 33522 on August 20, 1985 and were the subject of a notice of proposed rulemaking [LR-151-83 and LR-179-84, 1985-2 C.B. 808] published in the Federal Register at 50 FR 33552. Section 1.163-5T in its entirety was removed by T.D. 8110 [1987-1 C.B. 81], which was published in the Federal Register at 51 FR 45433 on December 19, 1986. However, it was not intended that §1.163-5T(d) should be removed.

Paragraph (f) of §35a.9999-5 consisting of Q & A 23 through 27 provides rules concerning the exclusion from portfolio interest of interest received by related parties. These temporary regulations were published in the Federal Register as T.D. 8111 [1987-1 C.B. 69], on December 19, 1986 at 51 FR 45484. In Notice 87-24, 1987-1 C.B. 470, the Internal Revenue Service stated that paragraph (f) of §35a.9999-5 of the temporary income tax regulations would be suspended retroactive to January 21, 1987, the date that the paragraph became effective.

EXPLANATION OF PROVISIONS

Section 1.163-5T(d) of these temporary regulations republishes the text of former §1.163-5T(d)(1) through (6) unchanged from the text as it was originally published (except for cross-references) in the Federal Register at 50 FR 33522 on August 20, 1985. These temporary regulations provide that a pass-through or participation certificate evidencing an interest in a pool of mortgage loans which under Subpart E of Subchapter J of the Code is treated as a trust of which the grantor is the owner (or similar evidence of interest in a similar pooled fund or pool trust treated as a grantor trust) ("pass-through certificate") is considered to be a "registration-required obligation" if the pass-through certificate is described in section 163(f)(2)(A), without regard to whether any obligation held by the fund or trust to which it relates is described in section 163(f)(2)(A). Also, a pass-through certificate is considered to satisfy the requirements of section 163(f)(2)(B) if it satisfies the requirements of section 163(f)(2)(B) without regard to the status of the underlying obligations. Mortgage pass-through certificates are therefore obligations to which section 163(f)(2)(A) or (B) may apply.

These temporary regulations do not affect the determination of whether bearer obligations that are issued or guaranteed by the United States Government or backed by United States Government securities comply with the requirements of section 163(f)(2)(B) and the regulations thereunder.

Section 35a.9999-5(f) applied generally to interest paid on obligations issued after January 20, 1987. Section 35a.9999-5(f) is deleted from the temporary regulations effective January 21, 1987 and, accordingly, section 35a.9999-5(f) does not apply to interest paid on obligations issued after January 20, 1987.

REGULATORY FLEXIBILITY ACT AND EXECUTIVE ORDER 12291

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required. The Internal Revenue Service has concluded that the regulations adopted hereby are interpretative and that the notice and public procedure requirements of 5 U.S.C. §553 do not apply. Accordingly, these regulations are not regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

* * * * *

Adoption of amendments to the regulations

The following amendments to 26 CFR Part 1 are hereby adopted:

Paragraph 1. The authority for Part 1 continues to read in part:

Authority: 26 U.S.C. 7805. ***

Par. 2. Section 1.163-5T is added after §1.163-5. The added section reads as follows:

§1.163-5T. Denial of Interest deduction on certain obligations issued after December 31, 1982, unless issued in registered form (temporary).

(a) [Reserved]

(b) [Reserved]

(c) [Reserved]

(d) *Pass-through certificates.*

(1) A pass-through or participation certificate evidencing an interest in a pool of mortgage loans which under Subpart E of Subchapter J of the Code is treated as a trust of which the grantor is the owner (or similar evidence of interest in a similar pooled fund or pooled trust treated as a grantor trust) ("pass-through certificate") is considered to be a "registration-required obligation" under section 163(f)(2)(A) and §1.163-5(c) if the pass-through certficate is described in section 163(f)(2)(A) and §1.163-5(c) without regard to whether any obligation held by the fund or trust to which the pass-through certificate relates is described in section 163(f)(2)(A) and §1.163-5(c). A pass-through certifi-

cate is considered to be described in section 163(f)(2)(B) and §1.163-5(c) if the pass-through certificate is described in section 163(f)(2)(B) and §1.163-5(c) without regard to whether any obligation held by the fund or trust to which the pass-through certificate relates is described in section 163(f)(2)(B) and §1.163-5(c).

(2) An obligation held by a fund or trust in which ownership interests are represented by pass-through certificates is considered to be in registered form under section 149(a) and the regulations thereunder or to be described in section 163(f)(2)(A) or (B), if the obligation held by the fund or trust is in registered form under section 149(a) and the regulations thereunder or is described in section 163(f)(2)(A) or (B), respectively, without regard to whether the pass-through certificate are so considered.

(3) For purposes of section 4701, a pass-through certificate is considered to be issued solely by the recipient of the proceeds from the issuance of the pass-through certificate (hereinafter the "sponsor"). The sponsor is therefore liable for any excise tax under section 4701 that may be imposed with reference to the principal amount of the pass-through certificate.

(4) In order to implement the purpose of section 163 §1.163-5(c) and this section, the Commissioner may characterize a certificate or other evidence of interest in a fund or trust which under Subpart E of Subchapter J of the Code is treated as a trust of which the grantor is the owner and any obligation held by such fund or trust in accordance with the substance of the arrangement they represent and may impose the penalties provided under section 163(f)(1) and 4701 in the appropriate amounts and on the appropriate persons. This provision may be applied, for example, where a corporation issues obligations purportedly in registered form, contributes them to a grantor trust as its only assets, and arranges for the sale to investors of bearer certificates of interest in the trust which do not meet the requirements of section 163(f)(2)(B). If this provision is applied, the obligations held by the fund or trust will not be considered to be issued in registered form or to meet the requirements of section 163(f)(2)(B). The corporation will not be allowed a deduction for the payment of interest on the obligations held by the trust, and the excise tax under section 4701, calculated with reference to the principal amount of the obligations held by the trust will be imposed on the corporation may be collected from the corporation and its agents. This paragraph (d)(4) will not be applied so as to alter the tax consequences of transactions as to which rulings have been issued by the Internal Revenue Service prior to September 19, 1985.

(5) The rules set forth in this paragraph (d) apply solely for purposes of sections 4701, 163(f)(2)(A), 163(f)(2)(B), §1.163-5(c), and any other section that refers to this section for the definition of the term "registration-required obligation" (such as the regulations under sections 871(h) and 881(c)). The treatment of obligations described in this paragraph (d) for purposes of section 163(f)(2)(A) and (B) does not affect the determination of whether bearer obligations that are issued or guaranteed by the United States Government, a United States Government-owned agency, a United States Government sponsored enterprise (within the meaning of §1.163-5(c)(1)) or that are backed (as described in the Treasury Department News Release R-2835 of September 10, 1984 and Treasury Department News Release R-2847 of September 14, 1984) by obligations issued by the United States Government, a United States Government-owned agency, or a United States Government sponsored enterprise comply with the requirements of section 163(f)(2)(B) and the regulations thereunder.

(6) The provisions of this paragraph (d)(1) through (5) may be illustrated by the following example:

Commercial Bank K forms a pool of 1000 residential mortgage loans, each made to a different individual homeowner, by assigning them to Commercial Bank L, an unrelated entity serving as trustee of the pool. Commercial Bank L immediately sells in a public offering certificates of interest in the trust of a maturity of 10 years in registered form. Commercial Bank L transfers the cash proceeds of the offering to Commercial Bank K. The certificates of interest in the trust are of a type offered to the public and are not described in section 163(f)(2)(B). Pursuant to paragraph (d)(1), the certificates of interest in the pool are registration-required obligations without regard to the fact that the obligations held by the trust are not registration-required obligations.

Par. 3. The authority for part 35a continues to read as follows:

Authority: 26 U.S.C. 7805. ***

Par. 4. In 35a.9999-5, paragraph (f) is removed.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved April 22, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 18, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 19, 1988, 53 F.R. 17927)

---

26 CFR 1.163-9T: Personal interest.

T.D. 8168

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953, PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Limitation on Deduction for Nonbusiness Interest; Personal Interest

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the treatment of personal interest and the treatment and determination of qualified residence interest. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations for the notice of proposed rulemaking on this subject *** [page 926, this Bulletin]. Changes to the applicable tax law were made by the Tax Reform Act of 1986. The regulations affect taxpayers other than corporations who have paid or accrued personal interest during a taxable year, and taxpayers who have paid or accrued interest on debt secured by a principal or second residence.

DATES: The regulations are effective for taxable years beginning after December 31, 1986.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document amends the Income Tax Regulations (26 CFR Part 1) and the Table of OMB Control Numbers (26 CFR Part 602) to provide rules under section 163(h) of the Internal Revenue Code of 1986. Section 163(h) was added to the Code by section 511(b) of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2246) [1986-3 C.B. (Vol. 1) 1, 163].

EXPLANATION OF STATUTORY PROVISIONS

Section 163(h)(1) provides that in the case of a taxpayer other than a corporation, no deduction shall be allowed under Chapter 1 of the Internal Revenue Code for personal interest paid or accrued during the taxable year. Section 163(h)(2) defines personal interest as any interest otherwise allowable as a deduction under chapter 1 of the Internal Revenue Code other than (a) interest paid or accrued on indebtedness properly allocable to the conduct of a trade or business (other than the trade or business of performing services as an employee), (b) investment interest, (c) interest taken into account under section 469 in computing income or loss from a passive activity, (d) qualified residence interest, or (e) interest payable under section 6601 on any unpaid portion of the tax imposed by section 2001 for the period during which an extension of time for payment of such tax is in effect under section 6163, 6166 or 6166A (as in effect before its repeal by the Economic Recovery Tax Act of 1981) [1981-2 C.B. 256].

Section 163(h)(3) defines qualified residence interest as interest paid or accrued on debt that is secured by a qualified residence at the time such interest is paid or accrued. Under section 163(h)(3)(B), however, interest expense constitutes qualified residence interest only to the extent that the underlying debt, when added to the principal balance of all other debt previously secured by the qualified residence, does not exceed the lesser of (a) the fair market value of the qualified residence, or (b) the sum of the taxpayer's basis in the qualified residence (adjusted only by the cost of any improvements) plus the amount of qualified indebtedness (secured medical and educational debt). Section 163(h)(3)(C) provides that for purposes of this limitation the taxpayer's basis in the qualified residence shall not be less than the principal balance of debt incurred prior to August 16, 1986, and secured by the qualified residence on August 16, 1986. Section 163(h)(3)(D) provides that, except as provided in regulations, any determination with respect to the limitation on the amount of qualified residence interest shall be made at the time the debt is incurred.

Qualified indebtedness is defined in section 163(h)(4) as debt secured by a qualified residence which is incurred after August 16, 1986, to pay for certain medical and educational expenses, which are paid or incurred within a reasonable period of time before or after such debt is incurred.

Section 163(h)(5) defines qualified residence as the principal residence of the taxpayer and one other residence designated by the taxpayer.

EXPLANATION OF REGULATORY PROVISIONS

The regulations adopt an annual test to determine whether a taxpayer's debt secured by a qualified residence ("secured debt") exceeds the section 163(h)(3)(B) limitation on qualified residence interest. An annual approach was chosen rather than a test applied only at the time a debt is incurred because an annual approach takes account of reductions in the principal balance of secured debt and, therefore, removes the incentive to refinance a secured debt in order to redetermine the limitation. Moreover, an annual test accounts more appropriately for lines of credit, the balance of which may fluctuate from year to year.

The regulations apply the annual test by comparing the section 163(h)(3)(B) limitation with the average principal balance of the debt during the taxable year. The average balance was selected over the principal balance of the debt on a particular day during the year (such as the first day of the year or the day on which the principal balance is the highest) because the average balance more accurately reflects the amount of debt outstanding over the course of the year and is more closely associated with the amount of interest paid.

Under the regulations, a taxpayer's basis in a residence (the "adjusted purchase price") is determined as of the end of each year, instead of at the time a debt is incurred. By providing for determination of the adjusted purchase price at the end of each year, the regulations permit a taxpayer to apply a single overall limitation to all secured debts, rather than a separate limitation for each debt. In addition, the use of an end-of-year adjusted purchase price permits taxpayers to take advantage of increases in the adjusted purchase price due to home improvements without the need to refinance debt.

In contrast, however, the regulations generally require the fair market value of the residence to be determined as of the time a debt is incurred. Limiting the fair market value determination to the date a debt is incurred will minimize controversy between taxpayers and the Service because the residence's fair market value with respect to any particular debt will be determined only once and because an independent appraisal ordinarily is conducted in connection with arm's length lending transactions.

In the case of a qualified residence that is real property, the regulations provide an irrebutable presumption that the fair market value is no less than the adjusted purchase price of the residence as of the end of the current taxable year. This presumption further reduces controversy between taxpayers and the Service over fair market value. It is believed that, in a broad range of circumstances, fair market value will in fact be at least as great as the adjusted purchase price.

These simplifications permit a taxpayer to determine whether all interest expense on secured debt is qualified residence interest by comparing the sum of the average balances for the taxable year of all secured debt to the adjusted purchase price determined as of the end of the year. If this sum is less than the adjusted purchase price, all of the interest paid or accrued on the secured debt is qualified residence interest. If the combined average balance exceeds the adjusted purchase price, the taxpayer must determine the amount of qualified residence interest using either the "simplified method" or the "exact method." (A taxpayer may use a different method for each qualified residence in each taxable year.)

Under the simplified method, the amount of qualified residence interest is determined by multiplying the total interest paid or accrued on all of the debt secured by a qualified residence by a fraction, the numerator of which is the adjusted purchase price and the denominator of which is the combined average balance. Any disallowed interest is treated as personal interest, the deduction for which is phased out over the period 1987 through 1990.

If a taxpayer wishes to take advantage of qualified indebtedness (secured medical and educational debt) or wishes to trace interest expense on secured debt to expenditures other than personal expenditures, the taxpayer must use the exact method. Under the exact method, the amount of qualified residence interest is determined on a debt-by-debt basis by comparing each debt to the applicable debt limit determined for that debt. If the average balance for any debt is less than its applicable debt limit, all of the interest paid or accrued on that debt is qualified residence interest. If the average balance exceeds its applicable debt limit, only a portion of the interest on the debt is qualified residence interest. The treatment of the remaining interest on the debt is determined by the use of the proceeds of the debt. If, for example, the proceeds of the debt were used to purchase investment assets, the remaining interest is investment interest subject to section 163(d).

The applicable debt limit for any debt is determined in two steps. First, the taxpayer determines the lesser of (a) the fair market value of the residence at the time the debt was secured, and (b) the sum of the adjusted purchase price (determined as of the end of the taxable year) plus the amount of qualified indebtedness for that debt and for all previously secured debt. Second, the taxpayer subtracts the average balance (or, if less, the applicable debt limit) of all previously secured debts from the amount so determined.

The regulations provide guidance on the determination of the amount of qualified indebtedness (*i.e.*, the amount of debt used to pay for qualified medical and educational expenses). If at least 90 percent of the proceeds of a secured debt are used to pay for qualified medical and educational expenses, the amount of qualified indebtedness is the average balance of the debt. If less than 90 percent of the proceeds of a secured debt are used to pay for such expenses, the amount of qualified indebtedness is the lesser of the average balance of the debt or the amount used to pay such expenses, reduced by principal payments on the debt in prior taxable years. The regulations provide rules for determining whether proceeds of a debt are used to pay for qualified medical or educational expenses. In general, a taxpayer may treat proceeds as being so used if medical or educational expenditures are made within 90 days before or after the date a debt is incurred. A taxpayer may also treat proceeds as being used to pay for such expenditures if the debt is traceable to such expenditures under the tracing rules provided in §1.163-8T.

The regulations also provide guidance regarding the determination of the aggregate outstanding principal amount of debt which was incurred on or before August 16, 1986, and secured by the qualified residence before August 16, 1986, (*i.e.*, the amount of grandfathered debt). In general, in any year, the grandfathered amount of such debt is the average balance of the debt during the taxable year. The regulations also permit a debt incurred to refinance a grandfathered debt to itself be treated as grandfathered debt. In cases where the taxpayer has borrowed new amounts after August 16, 1986, on a grandfathered debt or refinanced a grandfathered debt with a larger debt, the regulations provide appropriate limits on the grandfathered amount.

The regulations require that in order to be considered secured by a qualified residence, a debt must be secured by an instrument that makes the interest of the debtor in the qualified residence specific security for the payment of the debt and that is recorded in accordance with applicable State law. The regulations provide that a debt will be considered to be secured notwithstanding the fact that under an applicable State or local homestead law or other debtor protection law in effect on August 16, 1986, the security interest is ineffective or the enforceability of the security interest is restricted. This provision, which is consistent with provisions contained in pending technical corrections legislation, is intended to allow the benefit of the mortgage interest deduction despite state law impediments to securing mortgage debt. A taxpayer may elect to treat a debt that is secured by a qualified residence as if it were not secured by the residence.

The regulations provide guidance regarding the definition of a residence for purposes of section 163(h). They provide generally that a residence includes a house, condominium, cooperative, mobile home, boat or similar property which provides basic living accommodations, including sleeping space and toilet and cooking facilities. Additionally, if a portion of a residence is not used for residential purposes (*e.g.*, a room used as a home office), that portion does not qualify as a residence. In such cases, the taxpayer must allocate the fair market value and basis in the property (but not the average balance or interest on the debt) between the portion of the property used as a residence and the portion not so used.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis therefore is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The collection of information requirements contained in this regulation have been approved by the Office of Management and Budget (OMB) under section 3507 of the Paperwork Reduction Act.

* * * * *

Amendments to the regulations

For the reasons set out in the preamble, Title 26, Chapter 1, Subchapter A, Part 1 and Part 602 of the Code of Federal Regulations is amended as set forth below.

INCOME TAX REGULATIONS

(26 CFR Part 1)

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. *** Section 1.163-9T also issued under 26 U.S.C. 163(h)(3)(D). ***

Par. 2. The following new §§1.163-9T and 1.163-10T are added immediately after §1.163-8T.

§1.163-9T Personal interest (temporary).

(a) *In general.* No deduction under any provision of Chapter 1 of the Internal Revenue Code shall be allowed for personal interest paid or accrued during the taxable year by a taxpayer other than a corporation.

(b) *Personal interest*—(1) *Definition.* For purposes of this section, personal interest is any interest expense other than—

(i) Interest paid or accrued on indebtedness properly allocable (within the meaning of §1.163-8T) to the conduct of a trade or business (other than the trade or business of performing services as an employee),

(ii) Any investment interest (within the meaning of section 163(d)(3)),

(iii) Any interest that is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer,

(iv) Any qualified residence interest (within the meaning of section 163(h)(3) and §1.163-10T), and

(v) Any interest payable under section 6601 with respect to the unpaid portion of the tax imposed by section 2001 for the period during which an extension of time for payment of such tax is in effect under section 6163, 6166, or 6166A (as in effect before its repeal by the Economic Recovery Tax Act of 1981).

(2) *Interest relating to taxes*—(i) *In general.* Except as provided in paragraph (b)(2)(iii) of this section, personal interest includes interest—

(A) Paid on underpayments of individual Federal, State or local income taxes and on indebtedness used to pay such taxes (within the meaning of §1.168-8T), regardless of the source of the income generating the tax liability;

(B) Paid under section 453C(e)(4)(B) (interest on deferred tax resulting from certain installment sales) and section 1291(c) (interest on deferred tax attributable to passive foreign investment companies); or

(C) Paid by a trust, S corporation, or other pass-through entity on underpayments of State or local income taxes and on indebtedness used to pay such taxes.

(ii) *Example.* A, an individual, owns stock of an S corporation. On its return for 1987, the corporation underreports its taxable income. Consequently, A underreports A's share of that income on A's tax return. In 1989, A pays the resulting deficiency plus interest to the Internal Revenue Service. The interest paid by A in 1989 on the tax deficiency is personal interest, notwithstanding the fact that the additional tax liability may have arisen out of income from a trade or business. The result would be the same if A's business had been operated as a sole proprietorship.

(iii) *Certain other taxes.* Personal interest does not include interest—

(A) Paid with respect to sales, excise and similar taxes that are incurred in connection with a trade or business or an investment activity;

(B) Paid by an S corporation with respect to an underpayment of income tax from a year in which the S corporation was a C corporation or with respect to an underpayment of the taxes imposed by sections 1374 or 1375, or similar provision of State law; or

(C) Paid by a transferee under section 6901 (tax liability resulting from transferred assets), or a similar provision of State law, with respect to a C corporation's underpayment of income tax.

(3) *Cross references.* See §1.163-8T for rules for determining the allocation of interest expense to various activities. See §1.163-10T for rules concerning qualified residence interest.

(c) *Effective date*—(1) *In general.* The provisions of this section are effective for taxable years beginning after December 31, 1986. In the case of any taxable year beginning in calendar years 1987 through 1990, the amount of personal interest that is nondeductible under this section is limited to the applicable percentage of such amount.

(2) *Applicable percentage.* The applicable percentages for taxable years beginning in 1987 through 1990 are as follows:

1987: 35 percent
1988: 60 percent
1989: 80 percent
1990: 90 percent

§1.163-10T Qualified residence interest (temporary).

(a) *Table of contents.* This paragraph (a) lists the major paragraphs that appear in this section 1.163-10T.

(a) Table of contents.
(b) Treatment of qualified residence interest.
(c) Determination of qualified residence interest when secured debt does not exceed the adjusted purchase price.
(1) In general.
(2) Examples.
(d) Determination of qualified residence interest when secured debt exceeds adjusted purchase price—Simplified method.
(1) In general.
(2) Treatment of interest paid or accrued on secured debt that is not qualified residence interest.
(3) Example.
(e) Determination of qualified residence interest when secured debt exceeds adjusted purchase price—Exact method.
(1) In general.
(2) Determination of applicable debt limit.
(3) Example.
(4) Treatment of interest paid or accrued with respect to secured debt that is not qualified residence interest.
(i) In general.
(ii) Example.
(iii) Special rule if debt is allocated to more than one expenditure.
(iv) Example.
(f) Special rules.
(1) Special rules for personal property.
(i) In general.
(ii) Example.
(2) Special rule for real property.
(i) In general.
(ii) Example.
(g) Selection of method.
(h) Average balance.
(1) Average balance defined.
(2) Average balance reported by lender.
(3) Average balance computed on a daily basis.
(i) In general.

(ii) Example.
(4) Average balance computed using the interest rate.
(i) In general.
(ii) Points and prepaid interest.
(iii) Examples.
(5) Average balance computed using average of beginning and ending balance.
(i) In general.
(ii) Example.
(6) Highest principal balance.
(7) Other methods provided by the Commissioner.
(8) Anti-abuse rule.
(i) [Reserved.]
(j) Determination of interest paid or accrued during the taxable year.
(1) In general.
(2) Special rules for cash-basis taxpayers.
(i) Points deductible in year paid under section 461(g)(2).
(ii) Points and other prepaid interest described in section 461(g)(1).
(3) Examples.
(k) Determination of adjusted purchase price and fair market value.
(1) Adjusted purchase price.
(i) In general.
(ii) Adjusted purchase price of a qualified residence acquired incident to divorce.
(iii) Examples.
(2) Fair market value.
(i) In general.
(ii) Examples.
(3) Allocation of adjusted purchase price and fair market value.
(l) [Reserved].
(m) Grandfathered amount.
(1) Substitution for adjusted purchase price.
(2) Determination of grandfathered amount.
(i) In general.
(ii) Special rule for lines of credit and certain other debt.
(iii) Fair market value limitation.
(iv) Examples.
(3) Refinancing of grandfathered debt.
(i) In general.
(ii) Determination of grandfathered amount.
(4) Limitation on term of grandfathered debt.
(i) In general.
(ii) Special rule for nonamortizing debt.
(iii) Example.
(n) Qualified indebtedness (secured debt used for medical and educational purposes).
(1) In general.
(i) Treatment of qualified indebtedness.
(ii) Determination of amount of qualified indebtedness.
(iii) Determination of amount of qualified indebtedness for mixed-use debt.
(iv) Example.
(v) Prevention of double counting in year of refinancing.
(vi) Special rule for principal payments in excess of qualified expenses.
(2) Debt used to pay for qualified medical or educational expenses.
(i) In general.
(ii) Special rule for refinancing.
(iii) Other special rules.
(iv) Examples.
(3) Qualified medical expenses.
(4) Qualified educational expenses.
(o) Secured debt.
(1) In general.
(2) Special rule for debt in certain States.
(3) Time at which debt is treated as secured.
(4) Partially secured debt.
(i) In general.
(ii) Example.
(5) Election to treat debt as not secured by a qualified residence.
(i) In general.
(ii) Example.
(iii) Allocation of debt secured by two qualified residences.
(p) Definition of qualified residence.
(1) In general.
(2) Principal residence.
(3) Second residence.
(i) In general.
(ii) Definition of residence.
(iii) Use as a residence.
(iv) Election of second residence.
(4) Allocations between residence and other property.
(i) In general.
(ii) Special rule for rental of residence.
(iii) Examples.
(5) Residence under construction.
(i) In general.
(ii) Example.
(6) Special rule for time-sharing arrangements.
(q) Special rules for tenant- stockholders in cooperative housing corporations.
(1) In general.
(2) Special rule where stock may not be used to secure debt.
(3) Treatment of interest expense of the cooperative described in section 216(a)(2).
(4) Special rule to prevent tax avoidance.
(5) Other definitions.
(r) Effective date.

(b) *Treatment of qualified residence interest.* Except as provided below, qualified residence interest is deductible under section 163(a). Qualified residence interest is not subject to limitation or otherwise taken into account under section 163(d) (limitation on investment interest), section 163(h)(1) (disallowance of deduction for personal interest), section 263A (capitalization and inclusion in inventory costs of certain expenses) or section 469 (limitation on losses from passive activities). Qualified residence interest is subject to the limitations imposed by section 263(g) (certain interest in the case of straddles), section 264(a)(2) and (4) (interest paid in connection with certain insurance), section 265(a)(2) (interest relating to tax-exempt income), section 266 (carrying charges), section 267(a)(2) (interest with respect to transactions between related taxpayers), section 465 (deductions limited to amount at risk), section 1277 (deferral of interest deduction allocable to accrued market discount), and section 1282 (deferral of interest deduction allocable to accrued discount).

(c) *Determination of qualified residence interest when secured debt does not exceed adjusted purchase price*—(1) *In general.* If the sum of the average balances for the taxable year of all secured debts on a qualified residence does not exceed the adjusted purchase price (determined as of the end of the taxable year) of the qualified residence, all of the interest paid or accrued during the taxable year with respect to the secured debts is qualified residence interest. If the sum of the average balances for the taxable year of all secured debts exceeds the adjusted purchase price of the qualified residences (determined as of the end of the taxable year), the taxpayer must use either the simplified method (see paragraph (d) of this section) or the exact method (see paragraph (e) of this section) to determine the amount of interest that is qualified residence interest.

(2) *Examples.*

Examples (1). T purchases a qualified residence in 1987 for $65,000. T pays $6,500 in cash and finances the remainder of the purchase with a mortgage of $58,500. In 1988, the average balance of the mortgage is $58,000. Because the average balance of the mortgage is less than the adjusted purchase price of the residence ($65,000), all of the interest paid or accrued during 1988 on the mortgage is qualified residence interest.

Example (2). The facts are the same as in example (1), except that T incurs a second mortgage on January 1, 1988, with an initial principal balance of $2,000. The average balance of the second mortgage in 1988 is $1,900. Because the sum of the average balance of the first and second mortgages ($59,900) is less than the adjusted purchase price of the residence ($65,000), all of the interest paid or accrued during 1988 on both the first and second mortgages is qualified residence interest.

Example (3). P borrows $50,000 on January 1, 1988 and secures the debt by a qualified residence. P pays the interest on the debt monthly, but makes no principal payments in 1988. There are no other debts secured by the residence during 1988. On December 31, 1988, the adjusted purchase price of the residence is $40,000. The average balance of the debt in 1988 is $50,000. Because the average balance of the debt exceeds the adjusted purchase price ($10,000), some of the interest on the debt is not qualified residence interest. The portion of the total interest that is qualified residence interest must be determined in accordance with the rules of paragraph (d) or paragraph (e) of this section.

(d) *Determination of qualified residence interest when secured debt exceeds adjusted purchase price—Simplified method*—(1) *In general.* Under the simplified method, the amount of qualified residence interest for the taxable year is equal to the total interest paid or accrued during the taxable year with respect to all secured debts multiplied by a fraction (not in excess of one), the numerator of which is the adjusted purchase price (determined as of the end of the taxable year) of the qualified residence and the denominator of which is the sum of the average balances of all secured debts.

(2) *Treatment of interest paid or accrued on secured debt that is not qualified residence interest.* Under the simplified method, the excess of the total interest paid or accrued during the taxable year with respect to all secured debts over the amount of qualified residence interest is personal interest.

(3) *Example.* R's principal residence has an adjusted purchase price on December 31, 1988, of $105,000. R has two debts secured by the residence, with the following average balances and interest payments:

Debt	Date Secured	Average Balance	Interest
Debt 1	June 1983	$80,000	$8,000
Debt 2	May 1987	$40,000	$4,800
Total		$120,000	$12,800

The amount of qualified residence interest is determined under the simplified method by multiplying the total interest $12,800) by a fraction (expressed as a decimal amount) equal to the adjusted purchase price ($105,000) of the residence divided by the combined average balances $120,000). For 1988, this fraction is equal to 0.875 ($105,000/$120,000). Therefore, $11,200 ($12,800 x 0.875) of the total interest is qualified residence interest. The remaining $1,600 in interest ($12,800-$11,200) is personal interest, even if (under the rules of §1.163-8T) such remaining interest would be allocated to some other category of interest.

(e) *Determination of qualified residence interest when secured debt exceeds adjusted purchase price—Exact method*—(1) *In general.* Under the exact method, the amount of qualified residence interest for the taxable year is determined on a debt-by-debt basis by computing the applicable debt limit for each secured debt and comparing each such applicable debt limit to the average balance of the corresponding debt. If, for the taxable year, the average balance of a secured debt does not exceed the applicable debt limit for that debt, all of the interest paid or accrued during the taxable year with respect to the debt is qualified residence interest. If the average balance of the secured debt exceeds the applicable debt limit for that debt, the amount of qualified residence interest with respect to the debt is determined by multiplying the interest paid or accrued with respect to the debt by a fraction, the numerator of which is the applicable debt limit for that debt and the denominator of which is the average balance of the debt.

(2) *Determination of applicable debt limit.* For each secured debt, the applicable debt limit for the taxable year is equal to

(i) The lesser of—

(A) The fair market value of the qualified residence as of the date the debt is first secured, and

(B) The adjusted purchase price of the qualified residence as of the end of the taxable year,

(ii) Reduced by the average balance of each debt previously secured by the qualified residence.

For purposes of paragraph (e)(2)(ii) of this section, the average balance of a debt shall be treated as not exceeding the applicable debt limit of such debt. See paragraph (n)(1)(i) of this section for the rule that increases the adjusted purchase price in paragraph (e)(2)(i)(B) of this section by the amount of any qualified indebtedness (certain medical and educational debt). See paragraph (f) of this section for special rules relating to the determination of the fair market value of the qualified residence.

(3) *Example.* (*i*) R's principal residence has an adjusted purchase price on December 31, 1988, of $105,000. R has two debts secured by the residence. The average balances and interest payments on each debt during 1988 and fair market value of the residence on the date each debt was secured are as follows:

Debt	Date Secured	Fair Market Value	Average Balance	Interest
Debt 1	June 1983	$100,000	$80,000	$8,000
Debt	May 1987	$140,000	$40,000	$4,800
Total			$120,000	$12,800

(*ii*) The amount of qualified residence interest for 1988 under the exact method is determined as follows. Because there are no debts previously secured by the residence, the applicable debt limit for Debt 1 is $100,000 (the lesser of the adjusted purchase price as of the end of the taxable year and the fair market value of the residence at the time the debt was secured). Because the average balance of Debt 1 ($80,000) does not exceed its applicable debt limit ($100,000), all of the interest paid on the debt during 1988 ($8,000) is qualified residence interest.

(*iii*). The applicable debt limit for Debt 2 is $25,000 ($105,000 (the lesser of $140,000 fair market value and $105,000 adjusted purchase price) reduced by $80,000 (the average balance of Debt 1)). Because the average balance of Debt 2 ($40,000) exceeds its applicable debt limit, the amount of qualified residence interest on Debt 2 is determined by multiplying the amount of interest paid on the debt during the year ($4,800) by a fraction equal to its applicable debt limit divided by its average balance ($25,000/$40,000 = 0.625). Accordingly, $3,000 ($4,800 x 0.625) of the interest paid in 1988 on Debt 2 is qualified residence interest. The character of the remaining $1,800 of interest paid on Debt 2 is determined under the rules of paragraph (e)(4) of this section.

(4) *Treatment of interest paid or accrued with respect to secured debt that is not qualified residence interest*—(i) *In general.* Under the exact method, the excess of the interest paid or accrued during the taxable year with respect to a secured debt over the amount of qualified residence interest with respect to the debt is allocated under the rules of §1.163-8T.

(ii) *Example.* T borrows $20,000 and the entire proceeds of the debt are disbursed by the lender to T's broker to purchase securities held for investment. T secures the debt with T's principal residence. In 1990, T pays $2,000 of interest on the debt. Assume that under the rules of paragraph (e) of this section, $1,500 of the interest is qualified residence interest. The remaining $500 in interest expense would be allocated under the rules of §1.163-8T. Section 1.163-T generally allocates debt and the associated interest expense) by tracing disbursements of the debt proceeds to specific expenditures. Accordingly, the $500 interest expense on the debt that is not qualified residence interest is investment interest subject to section 163(d).

(iii) *Special rule if debt is allocated to more than one expenditure.* If—

(A) The average balance of a secured debt exceeds the applicable debt limit for that debt, and

(B) Under the rules of §1.163-8T, interest paid or accrued with respect to such debt is allocated to more than one expenditure,

the interest expense that is not qualified residence interest may be allocated among such expenditures, to the extent of such expenditures, in any manner selected by the taxpayer.

(iv) *Example.* (*i*) C borrows $60,000 secured by a qualified residence. C uses (within the meaning of §1.163-8T) $20,000 of the proceeds in C's trade or business, $20,000 to purchase stock held for investment and $20,000 for personal purposes. In 1990, C pays $6,000 in interest on the debt and, under the rules of §1.163-8T, $2,000 in interest is allocable to trade or business expenses, $2,000 to investment expenses and $2,000 to personal expenses. Assume that under paragraph (e) of this section, $2,500 of the interest is qualified residence interest and $3,500 of the interest is not qualified residence interest.

(*ii*) Under paragraph (e)(4)(iii) of this section, C may allocate up to $2,000 of the interest that is not qualified residence interest to any of the three categories of expenditures up to a total of $3,500 for all three categories. Therefore, for example, C may allocate $2,000 of such interest to C's trade or business and $1,500 of such interest to the purchase of stock.

(f) *Special rules*—(1) *Special rules for personal property*—(i) *In general.* If a qualified residence is personal property under State law (*e.g.*, a boat or motorized vehicle)—

(A) For purposes of paragraphs (c)(1) and (d)(1) of this section, if the fair market value of the residence as of the date that any secured debt (outstanding during the taxable year) is first secured by the residence is less than the adjusted purchase price as of the end of the taxable year, the lowest such fair market value shall be substituted for the adjusted purchase price.

(B) For purposes of paragraphs (e)(2)(i)(A) and (f)(1)(i)(A) of this section, the fair market value of the residence as of the date the debt is first secured by the residence shall not exceed the fair market value as of any date on which the taxpayer borrows any additional amount with respect to the debt.

(ii) *Example.* D owns a recreational vehicle that is a qualified residence under paragraph (p)(4) of this section. The adjusted purchase price and fair market value of the recreational vehicle is $20,000 in 1989. In 1989, D establishes a line of credit secured by the recreational vehicle. As of June 1, 1992, the fair market value of the vehicle has decreased to $10,000. On that day, D borrows an additional amount on the debt by using the line of credit. Although under paragraphs (e)(2)(i) and (f)(1)(i)(A) of this section, fair market value is determined at the time the debt is first secured, under paragraph (f)(1)(i)(B) of this section, the fair market value is the lesser of that amount or the fair market value on the most recent date that D borrows any additional amount with respect to the line of credit. Therefore, the fair market value with respect to the debt is $10,000.

(2) *Special rule for real property*—(i) *In general.* For purposes of paragraph (e)(2)(i)(A) of this section, the fair market value of a qualified residence that is real property under State law is presumed irrebuttably to be not less than the adjusted purchase price of the residence as of the last day of the taxable year.

(ii) *Example.* (*i*) C purchases a residence on August 11, 1987, for $50,000, incurring a first mortgage. The residence is real property under State law. During 1987, C makes $10,000 in home improvements. Accordingly, the adjusted purchase price of the residence as of December 31, 1988, is $60,000. C incurs a second mortgage on May 19, 1988, as of which time the fair market value of the value of the residence is $55,000.

(*ii*) For purposes of determining the applicable debt limit for each debt, the fair market value of the residence is generally determined as of the time the debt is first secured. Accordingly, the fair market value would be $50,000 and $55,000 with respect to the first and second mortgage, respectively. Under the special rule of paragraph (f)(2)(i) of this section, however, the fair market value with respect to both debts in 1988 is $60,000, the adjusted purchase price on December 31, 1988.

(g) *Selection of method.* For any taxable year, a taxpayer may use the simplified method (described in paragraph (d) of this section) or the exact method (described in paragraph (e) of this section) by completing the appropriate portion of Form 8598. A taxpayer with two qualified residences may use the simplified method for one residence and the exact method for the other residence.

(h) *Average balance*—(1) *Average balance defined.* For purposes of this section, the term "average balance" means the amount determined under this paragraph (h). A taxpayer is not required to use the same method to determine the average balance of all secured debts during a taxable year or of any particular secured debt from one year to the next.

(2) *Average balance reported by lender.* If a lender that is subject to section 6050H (returns relating to mortgage interest received in trade or business from individuals) reports the average balance of a secured debt on Form 1098, the taxpayer may use the average balance so reported.

(3) *Average balance computed on a daily basis*—(i) *In general.* The average balance may be determined by—

(A) Adding the outstanding balance of a debt on each day during the taxable year that the debt is secured by a qualified residence, and

best copy available

(B) Dividing the sum by the number of days during the taxable year that the residence is a qualified residence.

(ii) *Example.* Taxpayer A incurs a debt of $10,000 on September 1, 1989, securing the debt with A's principal residence. The residence is A's principal residence during the entire taxable year. A pays current interest on the debt monthly, but makes no principal payments. The debt is, therefore, outstanding for 122 days with a balance each day of $10,000. The residence is a qualified residence for 365 days. The average balance of the debt for 1989 is $3,342 (122 × $10,000/365).

(4) *Average balance computed using the interest rate*—(i) *In general.* If all accrued interest on a secured debt is paid at least monthly, the average balance of the secured debt may be determined by dividing the interest paid or accrued during the taxable year while the debt is secured by a qualified residence by the annual interest rate on the debt. If the interest rate on a debt varies during the taxable year, the lowest annual interest rate that applies to the debt during the taxable year must be used for purposes of this paragraph (h)(4). If the residence securing the debt is a qualified residence for less than the entire taxable year, the average balance of any secured debt may be determined by dividing the average balance determined under the preceding sentence by the percentage of the taxable year that the debt is secured by a qualified residence.

(ii) *Points and prepaid interest.* For purposes of paragraph (h)(4)(i) of this section, the amount of interest paid during the taxable year does not include any amount paid as points and includes prepaid interest only in the year accrued.

(iii) *Examples*—*Example (1).* B has a line of credit secured by a qualified residence for the entire taxable year. The interest rate on the debt is 10 percent throughout the taxable year. The principal balance on the debt changes throughout the year. B pays the accrued interest on the debt monthly. B pays $2,500 in interest on the debt during the taxable year. The average balance of the debt ($25,000) may be computed by dividing the total interest paid by the interest rate ($25,000 = $2,500/0.10).

Example (2). Assume the same facts as in example 1, except that the residence is a qualified residence, and the debt is outstanding, for only one-half of the taxable year and B pays only $1,250 in interest on the debt during the taxable year. The average balance of the debt may be computed by first dividing the total interest paid by the interest rate ($12,500 = $1,250/0.10). Second, because the residence is not a qualified residence for the entire taxable year, the average balance must be determined by dividing this amount ($12,500) by the portion of the year that the residence is qualified (0.50). The average balance is therefore $25,000 ($12,500/0.50).

(5) *Average balance computed using average of beginning and ending balances*—(i) *In general.* If—

(A) A debt requires level payments at fixed equal intervals (*e.g.*, monthly, quarterly) no less often than semi-annually during the taxable year,

(B) The taxpayer prepays no more than one month's principal on the debt during the taxable year, and

(C) No new amounts are borrowed on the debt during the taxable year,

the average balance of the debt may be determined by adding the principal balance as of the first day of the taxable year that the debt is secured by the qualified residence and the principal balance as of the last day of the taxable year that the debt is secured by the qualified residence and dividing the sum by 2. If the debt is secured by a qualified residence for less than the entire period during the taxable year that the residence is a qualified residence, the average balance may be determined by multiplying the average balance determined under the preceding sentence by a fraction, the numerator of which is the number of days during the taxable year that the debt is secured by the qualified residence and the denominator of which is the number of days during the taxable year that the residence is a qualified residence. For purposes of this paragraph (h)(5)(i), the determination of whether payments are level shall disregard the fact that the amount of the payments may be adjusted from time to time to take into account changes in the applicable interest rate.

(ii) *Example.* C borrows $10,000 in 1988, securing the debt with a second mortgage on a principal residence. The terms of the loan require C to make equal monthly payments of principal and interest so as to amortize the entire loan balance over 20 years. The balance of the debt is $9,652 on January 1, 1990, and is $9,450 on December 31, 1990. The average balance of the debt during 1990 may be computed as follows:

Balance on first day of the year:	$9,652
Balance on last day of the year:	$9,450
Average balance: $9,652 + $9,450 =	$9,551

(6) *Highest principal balance.* The average balance of a debt may be determined by taking the highest principal balance of the debt during the taxable year.

(7) *Other methods provided by the Commissioner.* The average balance may be determined using any other method provided by the Commissioner by form, publication, revenue ruling, or revenue procedure. Such methods may include methods similar to (but with restrictions different from) those provided in paragraph (h) of this section.

(8) *Anti-abuse rule.* If, as a result of the determination of the average balance of a debt using any of the methods specified in paragraphs (h)(4), (5), or (6) of this section, there is a significant overstatement of the amount of qualified residence interest and a principal purpose of the pattern of payments and borrowing on the debt is to cause the amount of such qualified residence interest to be overstated, the district director may redetermine the average balance using the method specified under paragraph (h)(3) of this section.

(i) [Reserved.]

(j) *Determination of interest paid or accrued during the taxable year*—(1) *In general.* For purposes of determining the amount of qualified residence interest with respect to a secured debt, the amount of interst paid or accrued during the taxable year includes only interest paid or accrued while the debt is secured by a qualified residence.

(2) *Special rules for cash-basis taxpayers*—(i) *Points deductible in year paid under section 461(g)(2).* If points described in section 461(g)(2) (certain points paid in respect of debt incurred in connection with the purchase or improvement of a principal residence) are paid with respect to a debt, the amount of such points is qualified residence interest.

(ii) *Points and other prepaid interest described in section 461(g)(1).* The amount of points or other prepaid interest charged to capital account under section 461(g)(1) (prepaid interest) that is qualified residence interest shall be determined under the rules of paragraphs (c) through (e) of this section in the same manner as any other interest paid with respect to the debt in the taxable year to which such payments are allocable under section 461(g)(1).

(e) *Examples.*

Example (1). T designates a vacation home as a qualified residence as of October 1, 1987. The home is encumbered by a mortgage during the entire taxable year. For purposes of determining the amount of qualified residence interst for 1987, T may take into account the interest paid or accrued on the secured debt from October 1, 1987, through December 31, 1987.

Example (2). R purchases a principal residence on June 17, 1987. As part of the purchase price, R obtains a conventional 30-year mortgage, secured by the residence. At closing, R pays 2 1/2 points on the mortgage and interest on the mortgage for the period June 17, 1987 through June 30, 1987. The points are actually paid by R and are not merely withheld from the loan proceeds. R incurs no additional secured debt during 1987. Assuming that the points satisfy the requirements of section 461(g)(2), the entire amount of points and the interest paid at closing are qualified residence interest.

Example (3). (*i*) On July 1, 1987, W borrows $120,000 to purchase a residence to use as a vacation home. W secures the debt with the residence. W pays 2 points, or $2,400. The debt has a term of 10 years and requires monthly payments of principal and interest. W is permitted to amortize the points at the rate of $20 per month over 120 months. W elects to treat the residence as a second residence. W has no other debt secured by the residence. The average balance of the debt in each taxable year is less than the adjusted purchase price of the residence. W sells the residence on June 30, 1990, and pays off the remaining balance of the debt.

(*ii*) W is entitled to treat the following amounts of the points as interest paid on a debt secured by a qualified residence—

1987:	$120	= $20 × 6 months;
1988:	$240	= $20 × 12 months;
1989:	$120	= $20 × 6 months.
TOTAL:	$480	

All of the interest paid on the debt, including the allocable points, is qualified residence interest. Upon repaying the debt, the remaining $1,920 ($2,400 − $480) in unamortized points is treated as interest paid in 1990 and, because the average balance of the secured debt in 1990 is less than the adjusted purchase price, is also qualified residence interest.

(k) *Determination of adjusted purchase price and fair market value*—(i) *Adjusted purchase price*—(i) *In general.* For purposes of this section, the adjusted purchase price of a qualified residence is equal to the taxpayer's basis in the residence as initially determined under section 1012 or other applicable sections of the Internal Revenue Code, increased by the cost of any improvements to the residence that have been added to the taxpayer's basis in the residence under section 1016(a)(1). Any other adjustments to basis, including those required under section 1033(b) (involuntary conversions), and 1034(e) (rollover of gain on sale of principal residence) are disregarded in determining the taxpayer's adjusted purchase price. If, for example, a taxpayer's second residence is rented for a portion of the year and its basis is reduced by depreciation allowed in connection with the rental use of the property, the amount of the taxpayer's adjusted purchase price in the residence is not reduced. See paragraph (m) of this section for a rule that treats the sum of the grandfathered amounts of all secured debts as the adjusted purchase price of the residence.

(ii) *Adjusted purchase price of a qualified residence acquired incident to divorce.* [Reserved.]

(iii) *Examples—Example (1).* X purchases a residence for $120,000. X's basis, as determined under section 1012, is the cost of the property, or $120,000. Accordingly, the adjusted purchase price of the residence is initially $120,000.

Example (2). Y owns a principal residence that has a basis of $30,000. Y sells the residence for $100,000 and purchases a new principal residence for a $120,000. Under section 1034, Y does not recognize gain on the sale of the former residence. Under section 1034(e), Y's basis in the new residence is reduced by the amount of gain not recognized. Therefore, under section 1034(e), Y's basis in the new residence is $50,000 ($120,000 − $70,000). For purposes of section 163(h), however, the adjusted purchase price of the residence is not adjusted under section 1034(e). Therefore, the adjusted purchase price of the residence is initially $120,000.

Example (3). Z acquires a residence by gift. The donor's basis in the residence was $30,000. Z's basis in the residence, determined under section 1015, is $30,000. Accordingly, the adjusted purchase price of the residence is initially $30,000.

(2) *Fair market value*—(i) *In general.* For purposes of this section, the fair market value of a qualified residence on any date is the fair market value of the taxpayer's interest in the residence on such date. In addition, the fair market value determined under this paragraph (k)(2)(i) shall be determined by taking into account the cost of improvements to the residence reasonably expected to be made with the proceeds of the debt.

(ii) *Example.* In 1988, the adjusted purchase price of P's second residence is $65,000 and the fair market value of the residence is $70,000. At that time, P incurs an additional debt of $10,000, the proceeds of which P reasonably expects to use to add two bedrooms to the residence. Because the fair market value is determined by taking into account the cost of improvements to the residence that are reasonably expected to be made with the proceeds of the debt, the fair market value of the residence with respect to the debt incurred in 1988 is $80,000 ($70,000 + $10,000).

(3) *Allocation of adjusted purchase price and fair market value.* If a property includes both a qualified residence and other property, the adjusted purchase price and the fair market value of such property must be allocated between the qualified residence and the other property. See paragraph (p)(4) of this section for rules governing such an allocation.

(l) [Reserved].

(m) *Grandfathered amount*—(1) *Substitution for adjusted purchase price.* If, for the taxable year, the sum of the grandfathered amounts, if any, of all secured debts exceeds the adjusted purchase price of the qualified residence, such sum may be treated as the adjusted purchase price of the residence underparagraphs (c), (d) and (e) of this section.

(2) *Determination of grandfathered amount*—(i) *In general.* For any taxable year, the grandfathered amount of any secured debt that was incurred on or before August 16, 1986, and was secured by the residence continuously from August 16, 1986, through the end of the taxable year, is the average balance of the debt for the taxable year. A secured debt that was not incurred and secured on or before August 16, 1986, has no grandfathered amount.

(ii) *Special rule for lines of credit and certain other debt.* If, with respect to a debt described in paragraph (m)(2)(i), a taxpayer has borrowed any additional amounts after August 16, 1986, the grandfathered amount of such debt is equal to the lesser of—

(A) The average balance of the debt for the taxable year, or

(B) The principal balance of the debt as of August 16, 1986, reduced (but not below zero) by all principal payments after August 16, 1986, and before the first day of the current taxable year.

For purposes of this paragraph (m)(2)(ii), a taxpayer shall not be considered to have borrowed any additional amount with respect to a debt merely because accrued interest is added to the principal balance of the debt, so long as such accrued interest is paid by the taxpayer no less often than quarterly.

(iii) *Fair market value limitation.* The grandfathered amount of any debt for any taxable year may not exceed the fair market value of the residence on August 16, 1986, reduced by the principal balance on that day of all previously secured debt.

(iv) *Examples—Example (1).* As of August 16, 1986, T has one debt secured by T's principal residence. The debt is a conventional self-amortizing mortgage and, on August 16, 1986, it has an outstanding principal balance of $75,000. In 1987, the average balance of the mortgage is $73,000. The adjusted purchase price of the residence as of the end of 1987 is $50,000. Because the mortgage was incurred and secured on or before August 16, 1986 and T has not borrowed any additional amounts with respect to the mortgage, the grandfathered amount is the average balance, $73,000. Because the grandfathered amount exceeds the adjusted purchase price ($50,000), T may treat the grandfathered amount as the adjusted purchase price in determining the amount of qualified residence interest.

Example (2). (*i*) The facts are the same as in example (1), except that in May 1986, T also obtains a home equity line of credit that, on August 16, 1986, has a principal balance of $40,000. In November 1986, T borrows an additional $10,000 on the home equity line, increasing the balance to $50,000. In December 1986, T repays $5,000 of principal on the home equity line. The average balance of the home equity line in 1987 is $45,000.

(*ii*) Because T has borrowed additional amounts on the line of credit after August 16, 1986, the grandfathered amount for that debt must be determined under the rules of paragraph (m)(2)(ii) of this section. Accordingly, the grandfathered amount for the line of credit is equal to the lesser of $45,000, the average balance of the debt in 1987, and $35,000, the principal balance on August 16, 1986, reduced by all principal payments between August 17, 1986, and December 31, 1986 ($40,000 − $5,000). The sum of the grandfathered amounts with respect to the residence is $108,000 ($73,000 + $35,000). Because the sum of the grandfathered amounts exceeds the adjusted purchase price ($50,000), T may treat the sum as the adjusted purchase price in determining the qualified residence interest for 1987.

(3) *Refinancing of grandfathered debt*—(i) *In general.* A debt incurred and secured on or before August 16, 1986, is refinanced if some or all of the outstanding balance of such a debt (the "original debt") is repaid out of the proceeds of a second debt secured by the same qualified residence (the "replacement debt"). In the case of a refinancing, the replacement debt is treated as a debt incurred and secured on or before August 16, 1986, and the grandfathered amount of such debt is the amount (but not less than zero) determined pursuant to paragraph (m)(3)(ii) of this section.

(ii) *Determination of grandfathered amount*—(a) *Exact refinancing.* If—

(*1*) The entire proceeds of a replacement debt are used to refinance one or more original debts, and

(*2*) The taxpayer has not borrowed any additional amounts after August 16, 1986, with respect to the original debt or debts,

the grandfathered amount of the replacement debt is the average balance of the replacement debt. For purposes of the preceding sentence, the fact that proceeds of a replacement debt are used to pay costs of obtaining the replacement debt (including points or other closing costs) shall be disregarded in determining whether the entire proceeds of the replacement debt have been used to refinance one or more original debts.

(B) *Refinancing other than exact refinancings—(1) Year of refinancing.* In the taxable year in which an original debt is refinanced, the grandfathered amount of the original and replacement debts is equal to the lesser of—

(*i*) The sum of the average balances of the original debt and the replacement debt, and

(*ii*) The principal balance of the original debt as of August 16, 1986, reduced by all principal payments on the original debt after August 16, 1986, and before the first day of the current taxable year.

(*2*) *In subsequent years.* In any taxable year after the taxable year in which an original debt is refinanced, the grandfathered amount of the replacement debt is equal to the least of—

(*i*) The average balance of the replacement debt for the taxable year,

(*ii*) The amount of the replacement debt used to repay the principal balance of the original debt, reduced by all principal payments on the replacement debt after the date of the refinancing and before the first day of the current taxable year, or

(*iii*) The principal balance of the original debt on August 16, 1986, reduced by all principal payments on the original debt after August 16, 1986, and before the date of the refinancing, and further reduced by all principal payments on the replacement debt after the date of the refinancing and before the first day of the current taxable year.

(C) *Example*—(*i*) *Facts.* On August 16, 1986, T has a single debt secured by a principal residence with a balance of $150,000. On July 1, 1988, T refinances the debt, which still has a principal balance of $150,000, with a new secured debt. The principal balance of the replacement debt throughout 1988 and 1989 is $150,000. The adjusted purchase price of the residence is $100,000 through 1987, 1988 and 1989. The average balance of the original debt was $150,000 in 1987 and $75,000 in 1988. The average balance of the replacement debt is $75,000 in 1988 and $150,000 in 1989.

(*ii*) *Grandfathered amount in 1987.* The original debt was incurred and secured on or before August 16, 1986 and T has not borrowed any additional amounts with respect to the debt. Therefore, its grandfathered amount in 1987 is its average balance ($150,000). This amount is treated as the adjusted purchase price for 1987 and all of the interest paid on the debt is qualified residence interest.

(*iii*) *Grandfathered amount in 1988.* Because the replacement debt was used to refinance a debt incurred and secured on or before August 16, 1986, the replacement debt is treated as a grandfathered debt. Because all of the proceeds of the replacement debt were used in the refinancing and because no amounts have been borrowed after August 16, 1986, on the original debt, the grandfathered amount for the original debt is its average balance ($75,000) and the grandfathered amount for the replacement debt is its average balance ($75,000). Since the sum of the grandfathered amounts ($150,000) exceeds the adjusted purchase price of the residence, the sum of the grandfathered amounts may be substituted for the adjusted purchase price for 1988 and all of the interest paid on the debt is qualified residence interest.

(*iv*) *Grandfathered amount in 1989.* The grandfathered amount for the replacement debt is its average balance ($150,000). This amount is treated as the adjusted purchase price for 1989 and all of the interest paid on the mortgage is qualified residence interest.

(4) *Limitation on term of grandfathered debt*—(i) *In general.* An original debt or replacement debt shall not have any grandfathered amount in any taxable year that begins after the date, as determined on August 16, 1986, that the original debt was required to be repaid in full (the "maturity date"). If a replacement debt is used to refinance more than one original debt, the maturity date is determined by reference to the original debt that, as of August 16, 1986, had the latest maturity date.

(ii) *Special rule for nonamortizing debt.* If an original debt was actually incurred and secured on or before August 16, 1986, and if as of such date the terms of such debt did not require the amortization of its principal over its original term, the maturity date of the replacement debt is the earlier of the maturity date of the replacement debt or the date 30 years after the date the original debt is first refinanced.

(iii) *Example.* C incurs a debt on May 10, 1986, the final payment of which is due May 1, 2006. C incurs a second debt on August 11, 1990, with a term of 20 years and uses the proceeds of the second debt to refinance the first debt. Because, under paragraph (m)(4)(i) of this section, a replacement debt will not have any grandfathered amount in any taxable year that begins after the maturity date of the original debt (May 1, 2006), the second debt has no grandfathered amount in any taxable year after 2006.

(n) *Qualified indebtedness (secured debt used for medical and educational purposes*—(1) *In general*—(i) *Treatment of qualified indebtedness.* The amount of any qualified indebtedness resulting from a secured debt may be added to the adjusted purchase price under paragraph (e)(2)(i)(B) of this section to determine the applicable debt limit for that secured debt and any other debt subsequently secured by the qualified residence.

(ii) *Determination of amount of qualified indebtedness.* If, as of the end of the taxable year (or the last day in the taxable year that the debt is secured), at least 90 percent of the proceeds of a secured debt are used (within the meaning of paragraph (n)(2) of this section) to pay for qualified medical and educational expenses (within the meaning of paragraphs (n)(3) and (n)(4) of this section), the amount of qualified indebtedness resulting from that debt for the taxable year is equal to the average balance of such debt for the taxable year.

(iii) *Determination of amount of qualified indebtedness for mixed-use debt.* If, as of the end of the taxable year (or the last day in the taxable year that the debt is secured), more than ten percent of the proceeds of a secured debt are used to pay for expenses other than qualified medical and educational expenses, the amount of qualified indebtedness resulting from that debt for the taxable year shall equal the lesser of—

(A) The average balance of the debt, or

(B) The amount of the proceeds of the debt used to pay for qualified medical and educational expenses through the end of the taxable year, reduced by any principal payments on the debt before the first day of the current taxable year.

(iv) *Example.* (*i*) C incurs a $10,000 debt on April 20, 1987, which is secured on that date by C's principal residence. C immediately uses (within the meaning of paragraph (n)(2) of this section) $4,000 of the proceeds of the debt to pay for a qualified medical expense. C makes no principal payments on the debt during 1987. During 1988 and 1989, C makes principal payments of $1,000 per year. The average balance of the debt during 1988 is $9,500 and the average balance during 1989 is $8,500.

(*ii*) Under paragraph (n)(1)(iii) of this section, C determines the amount of qualified indebtedness for 1988 as follows:

Average balance—		$9,500
Amount of debt used to pay for qualified medical expenses—	$4,000	
Less payments of principal before 1988—	$0	
Net qualified expenses—		$4,000

The amount of qualified indebtedness for 1988 is, therefore, $4,000 (lesser of $9,500 average balance or $4,000 net qualified expenses). This amount may be added to the adjusted purchase price of C's principal residence under paragraph (e)(2)(i)(B) of this section for purposes of computing the applicable debt limit for this debt and any other debt subsequently secured by the principal residence.

(*iii*) C determines the amount of qualified indebtedness for 1989 as follows:

Average balance—		$8,500
Amount of debt used to pay qualified medical expenses—	$4,000	
Less payments of principal before 1989—	$1,000	
Net qualified expenses—		$3,000

The amount of qualified indebtedness for 1989 is, therefore, $3,000 (lesser of $8,500 average balance or $3,000 net qualified expense).

(v) *Prevention of double counting in year of refinancing*—(A) *In general.* A debt used to pay for qualified medical or educational expenses is refinanced if some or all of the outstanding balance of the debt (the "original debt") is repaid out of the proceeds of a second debt (the "replacement debt"). If, in the year of a refinancing, the combined qualified indebtedness of the originial debt and the replacement debt exceeds the combined qualified expenses of such debts, the amount of qualified indebtedness for each such debt shall be determined by multiplying the amount of qualified indebtedness for each such debt by a fraction, the numerator of which is the combined qualified expenses and the denominator of which is the combined qualified indebtedness.

(B) *Definitions.* For purposes of paragraph (n)(1)(v)(A) of this section—

(*1*) The term "combined qualified indebtedness" means the sum of the qualified indebtedness (determined without regard to paragraph (n)(1)(v) of this section) for the original debt and the replacement debt.

(*2*) The term "combined qualified expenses" means the amount of the proceeds of the original debt used to pay for qualified medical and educational expenses through the end of the current taxable year, reduced by any principal payments on the debt before the first day of the current taxable year, and increased by the amount, if any, of the proceeds of the replacement debt used to pay such expenses through the end of the current taxable year other than as part of the refinancing.

(C) *Example.* (*i*) On August 11, 1987, C incurs a $8,000 debt secured by a principal residence. C uses (within the meaning of paragraph (n)(2)(i) of this section) $5,000 of the proceeds of the debt to pay for qualified educational expenses. C makes no principal payments on the debt. On July 1, 1988, C incurs a new debt in the amount of $8,000 secured by C's principal residence and uses all of the proceeds of the new debt to repay the original debt. Under paragraph (n)(2)(ii) of this section $5,000 of the new debt is treated as being used to pay for qualified educational expenses. C makes no principal payments (other than the refinancing) during 1987 or 1988 on either debt and pays all accrued interest monthly. The average balance of each debt in 1988 is $4,000.

(*ii*) Under paragraph (n)(1)(iii) of this section, the amount of qualified indebtedness for 1988 with respect to the original debt is $4,000 (the lesser of its average balance ($4,000) and the amount of the debt used to pay for qualified medical and educational expenses ($5,000)). Similarly, the amount of qualified indebtedness for 1988 with respect to the replacement debt is also $4,000. Both debts, however, are subject in 1988 to the limitation in paragraph (n)(1)(v)(A) of this section. The combined qualified indebtedness, determined without regard to the limitation, is $8,000 ($4,000 of qualified indebtedness from each debt). The combined qualified expenses are $5,000 ($5,000 from the original debt and $0 from the replacement debt). The amount of qualified indebtedness from each debt must, therefore, be reduced by a fraction, the numerator of which is $5,000 (the combined qualified expenses) and the denominator of which is $8,000 (the combined qualified indebtedness). After application of the limitation, the amount of qualified indebtedness for the original debt is $2,500 ($4,000 x 5/8). Similarly, the amount of qualified indebtedness for the replacement debt is $2,500. Note that the total qualified indebtedness for both the original and the replacement debt is $5,000 ($2,500 + $2,500). Therefore, C is entitled to the same amount of qualified indebtedness as C would have been entitled to if C had not refinanced the debt.

(vi) *Special rule for principal payments in excess of qualified expenses.* For purposes of paragraph (n)(1)(iii)(B), (n)(1)(v)(B)(*2*) and (n)(2)(ii) of this section, a principal payment is taken into account only to the extent that the payment, when added to all prior payments, does not exceed the amount used on or before the date of the payment to pay for qualified medical and educational expenses.

(2) *Debt used to pay for qualified medical or educational expenses*—(i) *In general.* For purposes of this section, the proceeds of a debt are used to pay for qualified medical or educational expenses to the extent that—

(A) The taxpayer pays qualified medical or educational expenses within 90 days before or after the date that amounts are actually borrowed with respect to the debt, the proceeds of the debt are not directly allocable to another expense under §1.163-8T(c)(3) (allocation of debt; proceeds not disbursed to borrower) and the proceeds of any other debt are not allocable to the medical or educational expenses under §1.163-8T(c)(3), or

(B) The proceeds of the debt are otherwise allocated to such expenditures under §1.163-8T.

(ii) *Special rule for refinancings.* For purposes of this section, the proceeds of a debt are used to pay for qualified medical and educational expenses to the extent that the proceeds of the debt are allocated under §1.163-8T to the repayment of another debt (the "original debt"), but only to the extent of the amount of the original debt used to pay for qualified medical and educational expenses, reduced by any principal payments on such debt up to the time of the refinancing.

(iii) *Other special rules.* The following special rules apply for purposes of this section.

(A) Proceeds of a debt are used to pay for qualified medical or educational expenses as of the later of the taxable year in which such proceeds are borrowed or the taxable year in which such expenses are paid.

(B) The amount of debt which may be treated as being used to pay for qualified medical or educational expenses may not exceed the amount of such expenses.

(C) Proceeds of a debt may not be treated as being used to pay for qualified medical or educational expenses to the extent that:

(*1*) The proceeds have been repaid as of the time the expense is paid;

(*2*) The proceeds are actually borrowed before August 17, 1986; or

(*3*) The medical or educational expenses are paid before August 17, 1986.

(iv) *Examples*—*Example (1).* A pays a $5,000 qualified educational expense from a checking account that A maintains at Bank 1 on November 9, 1987. On January 1, 1988, A incurs a $20,000 debt that is secured by A's residence and places the proceeds of the debt in a savings account that A also maintains at Bank 1. A pays another $5,000 qualified educational expense on March 15 from a checking account that A maintains at Bank 2. Under paragraph (n)(2) of this section, the debt proceeds are used to pay for both educational expenses, regardless of other deposits to, or expenditures from, the accounts, because both expenditures are made within 90 days before or after the debt was incurred.

Example (2). B pays a $5,000 qualified educational expense from a checking account on November 1, 1987. On November 30, 1987, B incurs a debt secured by B's residence, and the lender disburses the debt proceeds directly to a person who sells B a new car. Although the educational expense is paid within 90 days of the date the debt is incurred, the proceeds of the debt are not used to pay for the educational expense because the proceeds are directly allocable to the purchase of the new car under §1.163-8T(c)(3).

Example (3). On November 1, 1987, C borrows $5,000 from C's college. The proceeds of this debt are not disbursed to C, but rather are used to pay tuition fees for C's attendance at the college. On November 30, 1987, C incurs a second debt and secures the debt by C's residence. Although the $5,000 educational expense is paid within 90 days before the second debt is incurred, the proceeds of the second debt are not used to pay for the educational expense, because the proceeds of the first debt are directly allocable to the educational expense under §1.163-8T(c)(3).

Example (4). On January 1, 1988, D incurs a $20,000 debt secured by a qualified residence. D places the proceeds of the debt in a separate account (*i.e.*, the proceeds of the debt are the only deposit in the account). D makes payments of $5,000 each for qualified educational expenses on September 1, 1988, September 1, 1989, September 1, 1990, and September 1, 1991. Because the debt proceeds are allocated to educational expenses as of the date the expenses are paid, under the rules of §1.163-8T(c)(4), the following amounts of the debt proceeds are used to pay for qualified educational expenses as of the end of each year:

1988: $5,000
1989: $10,000
1990: $15,000
1991: $20,000

Example (5). During 1987 E incurs a $10,000 debt secured by a principal residence. E uses (within the meaning of paragraph (n)(2)(i) of this section) all of the proceeds of the debt to pay for qualified educational expenses. On August 20, 1988, at which time the balance of the debt is $9,500, E incurs a new debt in the amount of $9,500 secured by E's principal residence and uses all of the proceeds of the new debt to repay the original debt. Under paragraph (n)(2)(ii) of this section, all of the proceeds of the new debt are used to pay for qualified educational expenses.

(3) *Qualified medical expenses.* Qualified medical expenses are amounts that are paid for medical care (within the meaning of section 213(d)(1)(A) and (B)) for the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer (within the meaning of section 152), and that are not compensated for by insurance or otherwise.

(4) *Qualified educational expenses.* Qualified educational expenses are amounts that are paid for tuition, fees, books, supplies and equipment required for enrollment, attendance or courses of instruction at an educational organization described in section 170(b)(1)(A)(ii) and for any reasonable living expenses while away from home while in attendance at such an institution, for the taxpayer, the taxpayer's spouse or a dependent of the taxpayer (within the meaning of section 152) and that are not reimbursed by scholarship or otherwise.

(o) *Secured debt*—(1) *In general.* For purposes of this section, the term "secured debt" means a debt that is on the security of any instrument (such as a mortgage, deed of trust, or land contract)—

(i) That makes the interest of the debtor in the qualified residence specific security for the payment of the debt,

(ii) Under which, in the event of default, the residence could be subjected to the satisfaction of the debt with the same priority as a mortgage or deed of trust in the jurisdiction in which the property is situated, and

(iii) That is recorded, where permitted, or is otherwise perfected in accordance with applicable State law.

A debt will not be considered to be secured by a qualified residence if it is secured solely by virtue of a lien upon the general assets of the taxpayer or by a security interest, such as a mechanic's lien or judgment lien, that attaches to the property without the consent of the debtor.

(2) *Special rule for debt in certain States.* Debt will not fail to be treated as secured solely because, under an applicable State or local homestead law or other debtor protection law in effect on August 16, 1986, the security interest is ineffective or the enforceability of the security interest is restricted.

(3) *Time at which debt is treated as secured.* For purposes of this section, a debt is treated as secured as of the date on which each of the requirements of paragraph (o)(1) of this section are satisfied, regardless of when amounts are actually borrowed with respect to the debt. For purposes of this paragraph (o)(3), if the instrument is recorded within a commercially reasonable time after the security interest is granted, the instrument will be treated as recorded on the date that the security interest was granted.

(4) *Partially secured debt* (i) *In general.* If the security interest is limited to a prescribed maximum amount or portion of the residence, and the average balance of the debt exceeds such amount or the value of such portion, such excess shall not be treated as secured debt for purposes of this section.

(ii) *Example.* T borrows $80,000 on January 1, 1991. T secures the debt with a principal residence. The security in the residence for the debt, however, is limited to $20,000. T pays $8,000 in interest on the debt in 1991 and the average balance of the debt in that year is $80,000. Because the average balance of the debt exceeds the maximum amount of the security interest, such excess is not treated as secured debt. Therefore, for purposes of applying the limitation on qualified residence interest, the average balance of the secured debt is $20,000 (the maximum amount of the security interest) and the interest paid or accrued on the secured debt is $2,000 (the total interest paid on the debt multiplied by the ratio of the average balance of the secured debt ($20,000) and the average balance of the total debt ($80,000)).

(5) *Election to treat debt as not secured by a qualified residence*—(i) *In general.* For purposes of this section, a taxpayer may elect to treat any debt that is secured by a qualified residence as not secured by the qualified residence. An election made under this paragraph shall be effective for the taxable year for which the election is made and for all subsequent taxable years unless revoked with the consent of the Commissioner.

(ii) *Example.* T owns a principal residence with a fair market value of $75,000 and an adjusted purchase price of $40,000. In 1988, debt A, the proceeds of which were used to purchase the residence, has an average balance of $15,000. The proceeds of debt B, which is secured by a second mortgage on the property, are allocable to T's trade or business under §1.163-8T and has an average balance of $25,000. In 1988, T incurs debt C, which is also secured by T's principal residence and which has an average balance in 1988 of $5,000. In the absence of an election to treat debt B as unsecured, the applicable debt limit for debt C in 1988 under paragraph (e) of this section would be zero dollars ($40,000 − $15,000 − $25,000) and none of the interest paid on debt C would be qualified residence interest. If, however, T makes or has previously made an election pursuant to paragraph (o)(5)(i) of this section to treat debt B as not secured by the residence, the applicable debt limit for debt C would be $25,000 ($40,000 − $15,000), and all of the interest paid on debt C during the taxable year would be qualified residence interest. Since the proceeds of Debt B are allocable to T's trade or business under §1.163-8T, interest on Debt B may be deductible under other sections of the Internal Revenue Code.

(iii) *Allocation of debt secured by two qualified residences.* [Reserved.]

(p) *Definition of qualified residence*—(1) *In general.* The term "qualified residence" means the taxpayer's principal residence (as defined in paragraph (p)(2) of this section), or the taxpayer's second residence (as defined in paragraph (p)(3) of this section).

(2) *Principal residence.* The term "principal residence" means the taxpayer's principal residence within the meaning of section 1034. For purposes of this section, a taxpayer cannot have more than one principal residence at any one time.

(3) *Second residence*—(i) *In general.* The term "second residence" means—

(A) A residence within the meaning of paragraph (p)(3)(ii) of this section,

(B) That the taxpayer uses as a residence within the meaning of paragraph (p)(3)(iii) of this section, and

(C) That the taxpayer elects to treat as a second residence pursuant to paragraph (p)(3)(iv) of this section.

A taxpayer cannot have more than one second residence at any time.

(ii) *Definition of residence.* Whether property is a residence shall be determined based on all the facts and circumstances, including the good faith of the taxpayer. A residence generally includes a house, condominium, mobile home, boat, or house trailer, that contains sleeping space and toilet and cooking facilities. A residence does not include personal property, such as furniture or a television, that, in accordance with the applicable local law, is not a fixture.

(iii) *Use as a residence*—If a residence is rented at any time during the taxable year, it is considered to be used as a residence only if the taxpayer uses it during the taxable year as a residence within the meaning of section 280A(d). If a residence is not rented at any time during the taxable year, it shall be considered to be used as a residence. For purposes of the preceding sentence, a residence will be deemed to be rented during any period that the taxpayer holds the residence out for rental or resale or repairs or renovates the residence with the intention of holding it out for rental or resale.

(iv) *Election of second residence.* A taxpayer may elect a different residence (other than the taxpayer's principal residence) to be the taxpayer's second residence for each taxable year. A taxpayer may not elect different residences as second residences at different times of the same taxable year except as provided below—

(A) If the taxpayer acquires a new residence during the taxable year, the taxpayer may elect the new residence as the taxpayer's second residence as of the date acquired;

(B) If property that was the taxpayer's principal residence during the taxable year ceases to qualify as the taxpayer's principal residence, the taxpayer may elect that property as the taxpayer's second residence as of the date that the property ceases to be the taxpayer's principal residence; or

(C) If property that was the taxpayer's second residence is sold during the taxable year or becomes the taxpayer's principal residence, the taxpayer may elect a new second residence as of such day.

(4) *Allocations between residence and other property*—(i) *In general.* For purposes of this section, the adjusted purchase price and fair market value of property must be allocated between the portion of the property that is a qualified residence and the portion that is not a quali-

fied residence. Neither the average balance of the secured debt nor the interest paid or accrued on secured debt is so allocated. Property that is not used for residential purposes does not qualify as a residence. For example, if a portion of the property is used as an office in the taxpayer's trade or business, that portion of the property does not qualify as a residence.

(ii) *Special rule for rental of residence.* If a taxpayer rents a portion of his or her principal or second residence to another person (a "tenant"), such portion may be treated as used by the taxpayer for residential purposes if, but only if—

(A) Such rented portion is used by the tenant primarily for residential purposes,

(B) The rented portion is not a self-contained residential unit containing separate sleeping space and toilet and cooking facilities, and

(C) The total number of tenants renting (directly or by sublease) the same or different portions of the residence at any time during the taxable year does not exceed two. For this purpose, if two persons (and the dependents, as defined by section 152, of either of them) share the same sleeping quarters, they shall be treated as a single tenant.

(iii) *Examples—Example (1).* D, a dentist, uses a room in D's principal residence as an office which qualifies under section 280A(c)(1)(B) as a portion of the dwelling unit used exclusively on a regular basis as a place of business for meeting with patients in the normal course of D's trade or business. D's adjusted purchase price of the property is $65,000; $10,000 of which is allocable under paragraph (o)(4)(i) of this section to the room used as an office. For purposes of this section, D's residence does not include the room used as an office. The adjusted purchase price of the residence is, accordingly, $55,000. Similarly, the fair market value of D's residence must be allocated between the office and the remainder of the property.

Example (2). J rents out the basement of property that is otherwise used as J's principal residence. The basement is a self-contained residential unit, with sleeping space and toilet and cooking facilities. The adjusted purchase price of the property is $100,000; $15,000 of which is allocable under paragraph (o)(4)(i) of this section to the basement. For purposes of this section, J's residence does not include the basement and the adjusted purchase price of the residence is $85,000. Similarly, the fair market value of the residence must be allocated between the basement unit and the remainder of the property.

(5) *Residence under construction*—(i) *In general.* A taxpayer may treat a residence under construction as a qualified residence for a period of up to 24 months, but only if the residence becomes a qualified residence, without regard to this paragraph (p)(5)(i), as of the time that the residence is ready for occupancy.

(ii) *Example.* X owns a residential lot suitable for the construction of a vacation home. On April 20, 1987, X obtains a mortgage secured by the lot and any property to be constructed on the lot. On August 9, 1987, X begins construction of a residence on the lot. The residence is ready for occupancy on November 9, 1989. The residence is used as a residence within the meaning of paragraph (p)(3)(iii) of this section during 1989 and X elects to treat the residence as his second residence for the period November 9, 1989, through December 31, 1989. Since the residence under construction is a qualified residence as of the first day that the residence is ready for occupancy (November 9, 1987), X may treat the residence as his second residence under paragraph (p)(5)(i) of this section for up to 24 months of the period during which the residence is under construction, commencing on or after the date that construction is begun (August 9, 1987). If X treats the residence under construction as X's second residence beginning on August 9, 1987, the residence under construction would cease to qualify as a qualified residence under paragraph (p)(5)(i) on August 8, 1989. The residence's status as a qualified residence for future periods would be determined without regard to paragraph (p)(5)(i) of this section.

(6) *Special rule for time-sharing arrangements.* Property that is otherwise a qualified residence will not fail to qualify as such solely because the taxpayer's interest in or right to use the property is restricted by an arrangement whereby two or more persons with interests in the property agree to exercise control over the property for different periods during the taxable year. For purposes of determining the use of a residence under paragraph (p)(3)(iii) of this section, a taxpayer will not be considered to have used or rented a residence during any period that the taxpayer does not have the right to use the property or to receive any benefits from the rental of the property.

(q) *Special rules for tenant-stockholders in cooperative housing corporations*—(1) *In general.* For purposes of this section, a residence includes stock in a cooperative housing corporation owned by a tenant-stockholder if the house or apartment which the tenant-stockholder is entitled to occupy by virtue of owning such stock is a residence within the meaning of paragraph (p)(3)(ii) of this section.

(2) *Special rule where stock may not be used to secure debt.* For purposes of this section, if stock described in paragraph (q)(1) of this section may not be used to secure debt because of restrictions under local or State law or because of restrictions in the cooperative agreement (other than restrictions the principal purpose of which is to permit the tenant-stockholder to treat unsecured debt as secured debt under this paragraph (q)(2)), debt may be treated as secured by such stock to the extent that the proceeds of the debt are allocated to the purchase of the stock under the rules of §1.163-8T. For purposes of this paragraph (q)(2), proceeds of debt incurred prior to January 1, 1987, may be treated as allocated to the purchase of such stock to the extent that the tenant-stockholder has properly and consistently deducted interest expense on such debt as home mortgage interest attributable to such stock on Schedule A of Form 1040 in determining his taxable income for taxable years beginning before January 1, 1987. For purposes of this paragraph (q)(2), amended returns file after December 22, 1987, are disregarded.

(3) *Treatment of interest expense of the cooperative described in section 216(a)(2).* For purposes of section 163(h) and §1.163-9T (disallowance of deduction for personal interest) and section 163(d) (limitation on investment interest), any amount allowable as a deduction to a tenant-stockholder under section 216(a)(2) shall be treated as interest paid or accrued by the tenant-stockholder. If a tenant-stockholder's stock in a cooperative housing corporation is a qualified residence of the tenant-stockholder, any amount allowable as a deduction to the tenant-stockholder under section 216(a)(2) is qualified residence interest.

(4) *Special rule to prevent tax avoidance.* If the amount treated as qualified residence interest under this section exceeds the amount which would be so treated if the tenant-stockholder were treated as directly owning his proportionate share of the assets and liabilities of the cooperative and one of the principal purposes of the cooperative arrangement is to permit the tenant-stockholder to increase the amount of qualified residence interest, the district director

may determine that such excess is not qualified residence interest.

(5) *Other definitions.* For purpose of this section, the terms "tenant-stockholder," "cooperative housing corporation" and "proportionate share" shall have the meaning given by section 216 and the regulations thereunder.

(r) *Effective date.* The provisions of this section are effective for taxable years beginning after December 31, 1986.

REPORTING AND RECORDKEEPING REQUIREMENTS

(26 CFR Part 602)

Par. 3. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. Section 602.101(c) is amended by inserting in the appropriate place in the table "§1.163-10T . . . 1545-1009."

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impractical to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved December 15, 1987.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 21, 1987, 8:45 a.m., and published in the issue of the Federal Register for December 22, 1987, 52 F.R. 48407)

Section 167.—Depreciation

26 CFR 1.167(l)-2: Public utility property.

Rev. Proc. 85-57, 1985-2 C.B. 740, is expanded to cover communications from recognized consumer advocates. See Rev. Proc. 88-6, page 589.

Section 168.—Accelerated Cost Recovery System

Rev. Proc. 85-57, 1985-2 C.B. 740, is expanded to cover communications from recognized consumer advocates. See Rev. Proc. 88-6, page 589.

Certain asset classes and recovery periods relating to the Modified Accelerated Cost Recovery System are set out. See Rev. Proc. 88-22, page 785.

Section 170.—Charitable, etc., Contributions and Gifts

26 CFR 1.170A-4: Reduction in amount of charitable contributions of appreciated property.

T.D. 8176

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Treatment of Certain Charitable Contributions Relating to Bargain Sales

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that amend the method by which certain charitable contributions are to be reduced in calculating the allowable deduction in the case of bargain sales. These amendments conform the regulations to case law and are necessary to provide guidance to taxpayers relating to charitable contributions in the case of bargain sales.

DATES: The regulations are effective with respect to contributions paid and sales and exchanges made after December 31, 1969.

SUPPLEMENTARY INFORMATION:

BACKGROUND

In Estate of Bullard v. Commissioner, 87 T.C. 261 (July 31, 1986), the Tax Court invalidated §§1.170A-4 and 1.1011-2 of the Income Tax Regulations (26 CFR Part 1) to the extent they serve to disallow a charitable contribution deduction in the case of a bargain sale if the amount of the contribution was less than the section 170(e) reduction for the entire property (as opposed to just the contributed portion of the property). Section 170(e) provides, in part, that the amount of any charitable contribution otherwise taken into account under section 170 shall be reduced by the amount of gain that would have been recognized if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution).

EXPLANATION OF PROVISIONS

The amendments to the regulations provide that a charitable contribution deduction will be disallowed in the case of a bargain sale if the amount of the contribution is less than the section 170(e) reduction for the contributed portion of the property. In addition, examples in the regulations have been amended to conform to these amendments. This document does not conform the regulations to statutory changes to the Code subsequent to the adoption of the regulations by T.D. 7207.

SPECIAL ANALYSES

A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for final regulations subject to 5 U.S.C. 553(b)(B). Accordingly, the final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

The Commissioner of Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

Paragraph 1. The authority of Part 1 continues to read in part:

Authority: 26 U.S.C. 7805.***

Par. 2. Section 1.170A-4 is amended by revising paragraph (c)(2) and *Examples (5)* through *(10)* of paragraph (d) to read as set forth below:

§1.170-4 Reduction in amount of charitable contributions of appreciated property.

* * * * *

(c) ***

(2) *Bargain sale.* (i) Section 1011(b) and §1.1011-2 apply to bargain sales of property to charitable organizations. For purposes of applying the reduction rules of section 170(e)(1) and this section to the contributed portion of the property in the case of a bargain sale, there shall be allocated under section 1011(b) to the contributed portion of the property that portion of the adjusted basis of the entire property that bears the same ratio to the total adjusted basis as the fair market value of the contributed portion of the property bears to the fair market value of the entire property. For purposes of applying section 170(e)(1) and paragraph (a) of this section to the contributed portion of the property in such a case, there shall be allocated to the contributed portion the amount of gain that is not recognized on the bargain sale but that would have been recognized if such contributed portion had been sold by the donor at its fair market value at the time of its contribution to the charitable organization.

(ii) The term "bargain sale", as used in this subparagraph, means a transfer of property which is in part a sale or exchange of the property and in part a charitable contribution, as defined in section 170(c), of the property.

* * * * *

(d) ***

Example (5). In 1970, F, an individual calendar-year taxpayer, sells to a church for $4,000 ordinary income property with a fair market value of $10,000 and an adjusted basis of $4,000. F's contribution base for 1970 is $20,000, and F makes no other charitable contributions in 1970. Thus, F makes a charitable contribution to the church of $6,000 ($10,000 − $4,000 amount realized), which is 60% of the value of the property. The amount realized on the bargain sale is 40% ($4,000 / $10,000) of the value of the property. In applying section 1011(b) to the bargain sale, adjusted basis in the amount of $1,600 ($4,000 adjusted basis × 40%) is allocated under §1.1011-2(b) to the noncontributed portion of the property, and F recognizes $2,400 ($4,000 amount realized less $1,600 adjusted basis) of ordinary income. Under paragraphs (a)(1) and (c)(2)(i) of this section, F's contribution of $6,000 is reduced by $3,600 ($6,000 − [$4,000 adjusted basis × 60%]) (*i.e.*, the amount of ordinary income that would have been recognized on the contributed portion had the property been sold). The reduced contribution of $2,400 consists of the portion ($4,000 × 60%) of the adjusted basis not allocated to the noncontributed portion of the property. That is, the reduced contribution consists of the portion of the adjusted basis allocated to the contributed portion. Under sections 1012 and 1015(a) the basis of the property to the church is $6,400 ($4,000 + $2,400).

Example (6). In 1970, G, an individual calendar-year taxpayer, sells to a church for $6,000 ordinary income property with a fair market value of $10,000 and an adjusted basis of $4,000. G's contribution base for 1970 is $20,000, and G makes no other charitable contributions in 1970. Thus, G makes a charitable contribution to the church of $4,000 ($10,000 − $6,000 amount realized), which is 40% of the value of the property. The amount realized on the bargain sale is 60% ($6,000 / $10,000) of the value of the property. In applying section 1011(b) to the bargain sale, adjusted basis in the amount of $2,400 ($4,000 adjusted basis × 60%) is allocated under §1.1011-2(b) to the noncontributed portion of the property, and G recognizes $3,600 ($6,000 amount realized less $2,400 adjusted basis) of ordinary income. Under paragraphs (a)(1) and (c)(2)(i) of this section, G's contribution of $4,000 is reduced by $2,400 ($4,000 − [$4,000 adjusted basis × 40%]) (*i.e.*, the amount of ordinary income that would have been recognized on the contributed portion had the property been sold). The reduced contribution of $1,600 consists of the portion ($4,000 × 40%) of the adjusted basis not allocated to the noncontributed portion of the property. That is, the reduced contribution consists of the portion of the adjusted basis allocated to the contributed portion. Under sections 1012 and 1015(a) the basis of the property to the church is $7,600 ($6,000 + $1,600).

Example (7) In 1970, H, an individual calendar-year taxpayer, sells to a church for $2,000 stock held for not more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. H's contribution base for 1970 is $20,000, and H makes no other charitable contributions in 1970. Thus, H makes a charitable contribution to the church of $8,000 ($10,000 − $2,000 amount realized), which is 80% of the value of the property. The amount realized on the bargain sale is 20% ($2,000 / $10,000) of the value of the property. In applying section 1011(b) to the bargain sale, adjusted basis in the amount of $800 ($4,000 adjusted basis × 20%) is allocated under §1.1011-2(b) to the noncontributed portion of the property, and H recognizes $1,200 ($2,000 amount realized less $800 adjusted basis) of ordinary income. Under paragraphs (a)(1) and (c)(2)(i) of this section, H's contribution of $8,000 is reduced by $4,800 ($8,000 − [$4,000 adjusted basis × 80%]) (*i.e.*, the amount of ordinary income that would have been recognized on the contributed portion had the property been sold). The reduced contribution of $3,200 consists of the portion ($4,000 × 80%) of the adjusted basis not allocated to the noncontributed portion of the property. That is, the reduced contribution consists of the portion of the adjusted basis allocated to the contributed portion. Under sections 1012 and 1015(a) the basis of the property to the church is $5,200 ($2,000 + $3,200).

Example (8). In 1970, F, an individual calendar-year taxpayer, sells for $4,000 to a private foundation not described in section 170(b)(1)(E) property to which section 1245 applies which has a fair market value of $10,000 and an adjusted basis of $4,000. F's contribution base for 1970 is $20,000 and F makes no other charitable contributions in 1970. At the time of the bargain sale, F has used the property in his business for more than 6 months. Thus F makes a charitable contribution of $6,000 ($10,000 − $4,000 amount realized), which is 60% of the value of the property. The amount realized on the bargain sale is 40% ($4,000 / $10,000) of the value of the property. If the property had been sold by F at its fair market value at the time of its contribution, it is assumed that under section 1245 $4,000 of the gain of $6,000 ($10,000 − $4,000 adjusted basis) would have been treated as ordinary income and $2,000 would have been long-term capital gain. In applying section 1011(b) to the bargain sale, adjusted basis in the amount of $1,600 ($4,000 adjusted basis × 40%) is allocated under §1.1011-2(b) to the noncontributed portion of the property, and F's recognized gain of $2,400 ($4,000 amount realized less $1,600 adjusted basis) consists of $1,600 ($4,000 × 40%) of ordinary income and $800 ($2,000 × 40%) of long-term capital gain. Under paragraphs (a) and (c)(2)(i) of this section, F's contribution of $6,000 is reduced by $3,000 (the sum of $2,400 ($4,000 × 60%) of ordinary income and $600 ([$2,000 × 60%] × 50%) of long-term capital gain) (*i.e.*, the amount of gain that would have been recognized on the contributed portion had the property been sold). The reduced contribution of $3,000 consists of $2,400 ($4,000 × 60%) of adjusted basis and $600 ([$2,000 × 60%] × 50%) of long-term capital gain not used as a reduction under paragraph (a)(2) of this section. Under sections 1012 and 1015(a) the basis of the property to the private foundation is $6,400 ($4,000 + $2,400).

Example (9). ***

Example (10). (a) On July 1, 1970, B, a calendar-year individual taxpayer, sells to a church for $75,000 intangible property to which section 1245 applies which has a fair market value of $250,000 and an adjusted basis of $75,000. Thus, B makes a charitable contribution to the church of $175,000 ($250,000 − $75,000 amount realized), which is 70% ($175,000/$250,000) of the value of the property, the amount realized on the bargain sale is 30% ($75,000/$250,000) of the value of the property. At the time of the bargain sale, B has used the property in his business for more than 6 months. B's contribution base for 1970 is $500,000, and B makes no other charitable contributions in 1970. If the property had been sold by B at its fair market value at the time of its contribution, it is assumed that under section 1245 $105,000 of the gain of $175,000 ($250,000 − $75,000 adjusted basis) would have been treated as ordinary income and $70,000 would have been long-term capital gain. In applying section 1011(b) to the bargain sale, adjusted basis in the amount of $22,500 ($75,000 adjusted basis × 30%) is allocated under §1.1011-2(b) to the noncontributed portion of the property, and B's recognized gain of $52,500 ($75,000 amount realized less $22,500 adjusted basis) consists of $31,500 ($105,000 × 30%) of ordinary income and $21,000 ($70,000 × 30%) of long-term capital gain.

(b) Under paragraphs (a)(1) and (c)(2)(i) of this section B's contribution of $175,000 is reduced by $73,500 ($105,000 × 70%) (*i.e.*, the amount of ordinary income that would have been recognized on the contributed portion had the property been sold). The reduced contribution of $101,500 consists of $52,500 [$75,000 × 70%] of adjusted basis allocated to the contributed portion of the property and $49,000 [$70,000 × 70%] of long-term capital gain allocated to the contributed portion. Under sections 1012 and 1015(a) the basis of the property to the church is $127,500 ($75,000 + $52,500).

• • • • •

Par. 3. Section 1.1011-2 is amended by revising paragraph (a), *Examples (3)* through *(7)* of paragraph (c), and subparagraphs (a) and (b) of *Example (8)* of paragraph (c) to read as set forth below:

§1.1011-2 Bargain sale to a charitable organization.

(a) *In general.* (1) If for the taxable year a charitable contributions deduction is allowable under section 170 by reason of a sale or exchange of property, the taxpayer's adjusted basis of such property for purposes of determining gain from such sale or exchange must be computed as provided in section 1011(b) and paragraph (b) of this section. If after applying the provisions of section 170 for the taxable year, including the percentage limitations of section 170(b), no deduction is allowable under that section by reason of the sale or exchange of the property, section 1011(b) does not apply and the adjusted basis of the property is not required to be apportioned pursuant to paragraph (b) of this section. In such case the entire adjusted basis of the property is to be taken into account in determining gain from the sale or exchange, as provided in §1.1011-1(e). In ascertaining whether or not a charitable contributions deduction is allowable under section 170 for the taxable year for such purposes, that section is to be applied without regard to this section and the amount by which the contributed portion of the property must be reduced under section 170(e)(1) is the amount determined by taking into account the amount of gain which would have been ordinary income or long-term capital gain if the contributed portion of the property had been sold by the donor at its fair market value at the time of the sale or exchange.

• • • • •

(c) ***

Example (3). In 1970, C, a calendar-year individual taxpayer, makes a charitable contribution of $50,000 cash to a church. In addition, he sells for $4,000 to a private foundation not described in section 170(b)(1)(E) stock held for more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. Thus, C makes a charitable contribution of $6,000 of such property to the private foundation ($10,000 value − $4,000 amount realized). C's contribution base for 1970, as defined in section 170(b)(1)(F), is $100,000, and during that year he makes no other charitable contributions. By reason of section 170(b)(1)(A), the deduction allowed under section 170 for 1970 is $50,000 for the amount of cash contributed to the church. Under section 170(e)(1)(B)(ii) and paragraphs (a)(1) and (c)(2)(i) of §1.170A-4, the $6,000 contribution of stock is reduced to $4,800 ($6,000 − [50% × ($6,000 value of contributed portion of stock − $3,600 adjusted basis)]). However, by reason of section 170(b)(1)(B)(ii), applied without regard to section 1011(b), no deduction is allowed under section 170 for 1970 or any other year for the reduced contribution of $4,800 to the private foundation. Accordingly, paragraph (b) of this section does not apply for purposes of apportioning the adjusted basis of the stock sold to the private foundation, and under section 1.1011-1(e) the recognized gain on the bargain sale is $0 ($4,000 amount realized − $4,000 adjusted basis).

Example (4). In 1970, B, a calendar-year individual taxpayer, sells to a church for $2,000 stock held for not more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. B's contribution base for 1970, as defined in section 170(b)(1)(F), is $20,000 and during such year B makes no other charitable contributions. Thus, he makes a charitable contribution to the church of $8,000 ($10,000 value − $2,000 amount realized). Under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $800 ($4,000 adjusted basis × $2,000 amount realized/$10,000 value of stock). Accordingly, B, has a recognized short-term capital gain of $1,200 ($2,000 amount realized − $800 adjusted basis) on the bargain sale. After applying section 1011(b) and paragraphs (a)(1) and (c)(2)(i) of §1.170A-4, B is allowed a charitable contributions deduction for 1970 of $3,200 ($8,000 value of gift − [$8,000 − ($4,000 adjusted basis of property × $8,000 value of gift/$10,000 value of property)]).

Example (5). The facts are the same as in Example (4) except that B sells the property to the church for $4,000. Thus, B makes a charitable contribution to the church of $6,000 ($10,000 value − $4,000 amount realized). Under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $1,600 ($4,000 adjusted basis × $4,000 amount realized/$10,000 value of stock). Accordingly, B has a recognized short-term capital gain of $2,400 ($4,000 amount realized − $1,600 adjusted basis) on the bargain sale. After applying section 1011(b) and paragraphs (a)(1) and (c)(2)(i) of §1.170A-4, B is allowed a charitable contributions deduction for 1970 of $2,400 ($6,000 value of gift − [$6,000 − ($4,000 adjusted basis of property × $6,000 value of gift/$10,000 value of property]).

Example (6). The facts are the same as in Example (4) except that B sells the property to the church for $6,000. Thus, B makes a charitable contribution to the church of $4,000 ($10,000 value − $6,000 amount realized). Under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $2,400 ($4,000 adjusted basis × $6,000 amount realized/$10,000 value of stock). Accordingly, B has a recognized short-term capital gain of $3,600 ($6,000 amount realized − $2,400 adjusted basis) on the bargain sale. After applying section 1011(b) and paragraphs (a)(1) and (c)(2)(i) of §1.170A-4, B is allowed a charitable contributions deduction for 1970 of $1,600 ($4,000 value of gift − [$4,000 − ($4,000 adjusted basis of property × $4,000 value of gift/$10,000 value of property]).

Example (7). In 1970, C, a calendar-year individual taxpayer, sells to a church for $4,000 tangible personal property used in his business for more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. Thus, C makes a charitable contribution to the church of $6,000 ($10,000 value − $4,000 adjusted basis). C's contribution base for 1970, as defined in section 170(b)(1)(F) is $100,000 and during such year he makes no other charitable contributions. If C had sold the property at its fair market value at the time of its contribution, it is assumed that under section 1245 $4,000 of the gain of $6,000 ($10,000 value − $4,000 adjusted basis) would have been treated as ordinary income. Thus, there would have been long-term capital gain of $2,000. It is also assumed that the church does not put the property to an unrelated use, as defined in paragraph (b)(3) of §1.170A-4. Under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $1,600 ($4,000 adjusted basis × $4,000 amount realized/$10,000 value of property). Accordingly, C has a recognized gain of $2,400 ($4,000 amount realized − $1,600 adjusted basis) on the bargain sale, consisting of ordinary income of $1,600 ($4,000 ordinary income × $4,000 amount realized/$10,000 value of property) and of long-term capital gain of $800 ($2,000 long-term gain × $4,000 amount realized/$10,000 value of property). After applying section 1011(b) and paragraphs (a) and (c)(2)(i) of §1.170A-4, C is allowed a charitable contributions deduction for 1970 of $3,600 ($6,000 gift − [$4,000 ordinary income × $6,000 value of gift/$10,000 value of property]).

Example (8). (a) On January 1, 1970, A, a male of age 65, transfers capital assets consisting of securities held for more than 6 months to a church in exchange for a promise by the church to pay A a nonassignable annuity of $5,000 per year for life. The annuity is payable monthly with the first payment to be made on February 1, 1970. A's contribution base for 1970, as defined in section 170(b)(1)(F), is $200,000, and during that year he makes no other charitable contributions. On the date of transfer the securities have a fair market value of $100,000 and an adjusted basis to A of $20,000.

(b) The present value of the right of a male age 65 to receive a life annuity of $5,000 per annum, payable in equal installments at the end of each monthly period, is $59,755 ($5,000 × [11.469 − 0.482]), determined in accordance with section 101(b) of the Code, paragraph (e)(1)(iii)(b)(2) of §1.101-2, and section 3 of Rev. Rul. 62-216, C.B. 1962-2, 30. Thus, A makes a charitable contribution to the church of $40,245 ($100,000 − $59,755).

(c) Under paragraph (b) ***

* * * * *

This Treasury decision is not adverse to any taxpayer. For this reason, it is found unnecessary to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved February 9, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on February 24, 1988, 8:45 a.m., and published in the issue of the Federal Register for February 25, 1988, 53 F.R. 5568)

---

26 CFR 1.170A-6: Charitable contributions in trust.

Does a charitable "lead" annuity interest qualify as a guaranteed annuity interest if the trustee has the discretion to commute and prepay the charitable interest prior to the expiration of the specified term of the annuity. See Rev. Rul. 88-27, page 331.

---

26 CFR 1.170A-7: Contributions not in trust of partial interests in property.

Charitable contributions; oil and gas lease overriding royalty or net profits interest. The owner of a working interest under an oil and gas lease is not entitled to a charitable contribution deduction under section 170(a) of the Code for the contribution of an overriding royalty interest or a net profits interest.

Rev. Rul. 88-37

ISSUE

If the owner of the working interest under an oil and gas lease gives an overriding royalty interest or a net profits interest to a charitable organization, is the gift deductible as a charitable contribution under section 170(a) of the Internal Revenue Code?

FACTS

Situation 1. A, an individual, is the owner of the entire working interest under an oil and gas lease. During the taxable year, *A* donates to a charitable organization described in section 170(c) of the Code an overriding royalty interest equal to 10 percent of the gross production from *A*'s working interest under the lease.

Situation 2. The facts are the same except that the interest contributed is a net profits interest equal to 10 percent of the net profits from the donor's working interest.

LAW AND ANALYSIS

Section 170(a) of the Code provides, subject to certain limitations, a deduction for any charitable contribution (as defined in subsection (c)), payment of which is made within the taxable year.

Section 1.170A-1(c)(1) of the Income Tax Regulations provides that if a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property, reduced as provided in section 170(e) of the Code.

Section 170(f)(3) of the Code denies a charitable contribution deduction for certain contributions of partial interests in property. Section 170(f)(3)(A) provides that no charitable deduction is allowed for a contribution of less than the taxpayer's entire interest in property unless the value of the interest contributed would have been allowed as a deduction under section 170(f)(2) had it been transferred in trust.

Section 170(f)(2) of the Code provides, in the case of property transferred in trust, that a charitable deduction is allowed if the trust is a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. Further, a deduction is allowed for the value of an interest in property (other than a remainder interest) transferred in trust if the interest is in the form of a guaranteed annuity or the trust instrument specifies that the interest is a fixed percentage distributed yearly of the fair market value of the trust property and the grantor is treated as the owner of such interest for purposes of applying section 671.

By its terms, section 170(f)(3)(A) does not apply to a contribution of an interest that, even though partial, is the taxpayer's entire interest in the property. If, however, the property in which such partial interest exists was divided in order to create such interest and thus avoid section 170(f)(3)(A), and deduction is not allowed. Section 1.170A-7(a)(2)(i) of the regulations.

Section 170(f)(3)(B)(ii) of the Code and section 1.170A-7(b) of the regulations provide that a deduction is allowed under section 170 of the Code for a contribution not in trust of a partial interest that is less than the donor's entire interest in property if the partial interest is an undivided portion of the donor's entire interest. An undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property. A charitable contribution in perpetuity of an interest in property not in trust will not be considered a contribution of an undivided portion if the donor transfers some specific rights and retains other substantial rights.

In enacting section 170(f)(3), Congress was concerned with situations in which taxpayers might obtain a double benefit by taking a deduction for the present value of a contributed interest while also excluding from income subsequent receipts from the donated interest. In addition, Congress was concerned with situations in which, because the charity does not obtain all or an undivided portion of the significant rights in the property, the amount of a charitable contribution deduction might not correspond to the value of the benefit ultimately received by charity. The legislative solution was to guard against the possibility that such problems might arise by denying a deduction in situations involving partial interests unless the donation is cast in certain prescribed forms. *See* H.R. Rep. No. 91-413, 91st Cong., 1st Sess., 57-58 (1969), 1969-3 C.B. 200, 237; S. Rep. No. 91-552, 91st Cong., 1st Sess. 87 (1969), 1969-3 C.B. 423, 479. The scope of section 170(f)(3) thus extends beyond situations in which there is actual or probable manipulation of the non-charitable interest to the detriment of the charitable interest, or situations in which the donor has merely assigned the right to future income. *Compare Estate of Brock v. Commissioner*, 71 T.C. 901 (1979), *eff'd per curiam*, 630 F.2d 368 (5th Cir. 1980).

A working interest is the operating interest under an oil and gas lease. It is typically created by a transaction in which the owner of a tract of land, or the owner of the mineral rights to a tract of land, grants the right to exploit the oil and gas under the land, while at the same time retaining a royalty interest in production. Alternatively, the owner of a tract of land, or the owner of mineral rights to a tract of land, may, as in the instant case, retain the working interest and grant a royalty interest to another person. The owner of the working interest has the exclusive right to exploit the oil and gas resources. For federal tax purposes, a working interest is defined as an interest in oil and gas in place that is burdened with the cost of development and operation of the property. *Brooks v. Commissioner*, 424 F.2d 116 (5th Cir. 1970).

An overriding royalty interest is an economic interest in oil and gas in place, created from the working interest. An overriding royalty entitles its owner to a specified fraction of gross production, free of operating and developing costs. The term of an overriding royalty interest is coextensive with the term of the working interest from which it was created. The transfer of an overriding royalty is an assignment of a property interest and is not an anticipatory assignment of income. *See* Rev. Rul. 67-118, 1967-1 C.B. 163.

A net profits interest is, for federal tax purposes, an interest in oil and gas in place that is defined as a share of gross production measured by net profits from operation of the property. It is created out of the working interest and has the same duration. Unlike the income accruing to an overriding royalty, the income accruing to the net profits interest is reduced by specified operating and development costs, but the interest bears these expenses only to the extent of its share of the income. Unlike the working interest, the net profits interest is not required to pay out, advance, or become liable for such costs. *Burns v. Commissioner*, 78 T.C. 185, 209 (1982). Like a transfer of an overriding royalty, the transfer of such a net profits interest conveys, for federal tax purposes, a depletable property interest in oil and gas in place. *See Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599 (1946), 1946-1 C.B. 69; *Burton-Sutton Oil Co., Inc. v. Commissioner*, 328 U.S. 25 (1946), 1946-1 C.B. 237.

The right to exploit the oil and gas resources under the land is a right inherent in the ownership of a working interest. Even an owner of only a percentage of the working interest has the right to participate in decisions on the exploitation of the oil and gas resources. The owner of an overriding royalty interest or a net profits interest does not have this right.

In Rev. Rul. 81-282, 1981-2 C.B. 78, an individual donated stock in a corporation to a charitable organization but retained the right to vote the contributed shares. The ruling notes that the right to vote stock is inherent in the ownership of common stock and, as such, is a property right. This right gives the holder a voice in the management of the corporation and is crucial in protecting the stockholder's financial interest. Therefore, the ruling concludes that the right to vote the stock is a substantial right in that stock. The ruling points out that although the taxpayer's retention of the right to vote the stock would not defeat the donee's interest in the transferred property, nevertheless, the taxpayer did not transfer all substantial rights in the stock to *Y*. The ruling holds that a deduction under section 170 is not allowed because the taxpayer transferred only a partial interest in the property and the interest assigned was not an undivided portion. *See also* Rev. Rul. 76-143, 1976-1 C.B. 63.

In Rev. Rul. 76-331, 1976-2 C.B. 52, *Situation 1*, a corporation transferred a tract of land to a charitable organization but retained all mineral rights with respect to the land, including the sole right to exploit any minerals obtained from the property. The ruling holds that a deduction under section 170 is not allowed because the taxpayer retained a substantial interest or right in the property and cannot be considered as donating an undivided portion of the taxpayer's entire interest. In 1980, Congress provided for a deduction in such a situation by adding an exception to section 170(f)(3) of the Code in the case of a "qualified conservation contribution." *See* sections 170(f)(3)(B)(iii) and 170(h)(2)(A) of the Code. The holding of Rev. Rul. 76-331 remains valid, however, for contributions that do not satisfy the requirements of a qualified conservation contribution.

In both *Situation 1* and *Situation 2* of the present ruling, even though the working interest was itself only a partial interest in the land, it was the individual's entire interest prior to the transfer to charity. Assuming, therefore, that the property in which the working interest existed was not previously divided in order to avoid section 170(f)(e)(A), and assuming that the other requirements of section 170 were met, a deduction would be allowable for the contribution of all or an undivided portion of the working interest. *See* sections 1.170A-7(a)(2)(i) and 1.170A-7(b)(1)(i) of the regulations; Rev. Rul. 76-523, 1976-2 C.B. 54.

In both *Situations 1* and *2*, however, the donor did not contribute the donor's entire interest in the property but carved out and contributed only a portion of that interest. Further, the portion contributed was not an undivided portion of the donor's interest because it did not convey a fraction of each and every substantial interest or right owned by the donor in the property. By transferring an overriding royalty interest or a net profits interest, the donor has retained the right inherent in the ownership of a working interest to control, or, in the case of ownership of a part of the working interest, to participate in the control of, the development and operation of the lease. This right to control or to participate in control, similar to the retained voting rights in Rev. Rul. 81-282, is a substantial right, the retention of which prevents the donated interest from being considered an undivided portion.

After the transfer, in both *Situations 1* and *2*, the contributed interest is a separate property interest for federal tax purposes. However, if the charitable interest is created by dividing a greater interest held by the donor, the application of section 170(f)(3) to deny the charitable contribution deduction is not precluded merely because the contributed interest is a separate property in the hands of the donee and the incidence of taxation on income from the contributed interest is shifted from the donor to the donee. Rev. Rul. 70-477, 1970-2 C.B. 62, for example, holds that for years after the effective date of section 170(f)(3), a contribution of the rent-free use of property, even if recognized as a conveyance of property under local law, does not give rise to a deduction under section 170.

In both *Situation 1* and *Situation 2*, therefore, the contributed interest is less than the taxpayer's entire interest within the meaning of section 170(f)(3) of the Code, and is not an undivided portion of the taxpayer's entire interest. In each case, the partial interest was not transferred in trust and was not in a form that would have resulted in an allowable deduction under section 170(f)(2) had it been transferred in trust.

HOLDING

In both *Situation 1* and *Situation 2* no deduction is allowed under section 170 of the Code.

---

26 CFR 1.170A-13: Recordkeeping and return requirements for deductions for charitable contributions.
(Also Section 6050L; 1.6050L-1.)

T.D. 8199

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; SUBCHAPTER H, PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Deductions in Excess of $5,000 Claimed For Certain Charitable Contributions of Property and Information Returns by Donees Who Make Certain Dispositions of Donated Property

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document removes temporary regulations and provides final regulations relating to deductions in excess of $5,000 claimed for charitable contributions of property and to information returns by charitable donees that make certain dispositions of donated property. Changes to the applicable tax law were made by section 155 of the Tax Reform Act of 1984 (the "1984 Act"). The final regulations provide substantiation requirements with which certain donors must comply in order to obtain deductions for charitable contributions of certain property. In addition, the final regulations provide guidance regarding the filing of information returns by donees when they make certain dispositions of donated property.

DATES: Except as otherwise provided in this document, the regulations apply to certain charitable contributions of property made after December 31, 1984.

SUPPLEMENTARY INFORMATION

BACKGROUND

On December 31, 1984, the FEDERAL REGISTER published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 170 and 6050L of the Internal Revenue Code of 1954, as well as temporary regulations (T.D. 8003)[1985-1 C.B. 64] containing the same rules. The amendments were proposed to conform the regulations to section 155 of the 1984 Act. A hearing was held on June 28, 1985. After consideration of all comments regarding the proposed amendments, those amendments are adopted as revised by this Treasury Decision. These regulations supersede the temporary regulations issued under §§1.170A-13T and 1.6050L-1T.

SUMMARY OF COMMENTS

SUBSTANTIATION WITH A RECEIPT

Several commentators stated that temporary §1.170A-13T(b)(1)(iii) might be interpreted to require a donee to estimate the fair market value of contributed property. Therefore, the provision has been amended to clarify that fair market value is one of the circumstances to be taken into account by a donee in determining the amount of detail to provide in the description of the property included on the receipt. The fair market value of the property does not have to be stated on the receipt.

SUBSTANTIATION REQUIREMENTS FOR THE DEDUCTIBILITY OF CERTAIN CHARITABLE CONTRIBUTIONS

The final regulations provide that, pursuant to section 170(a)(1) of the Code, a deduction for certain charitable contributions made after December 31, 1984, by an individual, closely held corporation, personal service corporation, partnership, or S corporation shall not be allowed unless the donor complies with certain substantiation requirements. These requirements apply to contributions of property (other than money and publicly traded securities to which §1.170A-13(c)(7)(xi)(B) does not apply) if the donor claims or reports charitable contribution deductions for such item of property and all similar items of property for the same taxable year (whether or not donated to the same donee) that exceed, in the aggregate, $5,000. For such a contribution the donor must obtain a qualified appraisal and attach an appraisal summary to the return on which the deduction is first claimed.

In the case of nonpublicly traded stock, if the amount claimed or reported as a deduction is greater than $5,000 but does not exceed $10,000, the donor does not have to obtain a qualified appraisal. However, in such a case the donor must attach a partially completed appraisal summary form to the tax or information return on which the deduction is first claimed or reported. The same requirements apply with respect to publicly traded securities to which paragraph (c)(7)(xi)(B) applies.

Several commentators stated that the qualified appraisal requirement should not apply to nonpublicly traded stock subject to a buy-sell or redemption agreement. Although in certain cases a buy-sell or redemption agreement can be highly indicative of the fair market value of the subject stock, this is by no means always the case. Because of questions as to the financial stability of the purchasing party, the time value of money (when the agreement only applies at some future date), and agreements that may indicate a maximum but not a minimum value of the subject stock, it was decided not to include a special rule with respect to such agreements. In those instances where the agreement is a good indication of value, the qualified appraisal should be relatively easy to obtain.

Several commentators questioned how the substantiation requirements apply to contributions of partial interests. In response to these inquiries, §1.170A-13(c)(2)(i)(A) of the final regulations has been amended to provide that, if the contributed property is a partial interest, the qualified appraisal is to be made of the partial interest.

One commentator suggested that the substantiation requirements not be applied to contributions of property to which section 170(e)(3) applies unless the amount claimed as a deduction with respect to the property during a taxable year exceeds the donor's cost basis in the property by $5,000. This suggestion is supported by the fact that, if the taxpayer sold the property instead of donating it, the taxpayer would be entitled to a cost of goods sold deduction with respect to the property pursuant to §1.61-3. Section 1.170A-13(c)(1)(ii) of the final regulations requires an appraisal of property described in section 170(e)(3) or (4) only if the amount of the charitable deduction claimed exceeds the deduction otherwise available by $5,000.

SUBSTANTIATION REQUIREMENTS FOR C CORPORATIONS

The final regulations require certain C corporations (as defined in section 1361(a)(2)) to file with the Internal Revenue Service a partially completed appraisal summary for contributions of property that exceed the $5,000 threshold made after June 6, 1988. This requirement is included in the final regulations, in part, to provide a means of informing the donee (who must sign the summary) of the donee's reporting requirement under section 6050L. In addition, a notice of proposed rulemaking that applies all the substantiation requirements contained in §1.170A-13(c) to all taxpayers (including C corporations, trusts, estates, and pooled income funds) is being published in *** [LR-83-87, page 930, this Bulletin].

QUALIFIED APPRAISAL

The final regulations provide that a qualified appraisal is an appraisal document that (a) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property, or later than the date specified in §1.170A-13(c)(3)(iv)(B), (b) is prepared, signed, and dated by a qualified appraiser, and (c) does not involve a prohibited type of appraisal fee. In response to confusion expressed by some commentators regarding the timing of an appraisal performed subsequent to the contribution, the final regulations clarify that an appraisal can be made up until the date on which it must be received by the donor. It must be received by the donor before the due date (including extensions) of the return on which the deduction for the contributed property is first claimed (or reported in the case of a donor that is a partnership or S corporation) or, in the case of a deduction first claimed (or reported) on an amended return, the date on which the return is filed.

Several commentators suggested that the 60-day period be extended. The suggestion has not been incorporated into the final regulations because the Internal Revenue Service is concerned that an appraisal prepared more than 60 days before the date of contribution may not reflect the proper fair market value of the property. Thus, if the appraisal is performed more than 60 days prior to the contribution, it must be updated within the period specified in §1.170A-13(c)(3)(iv)(B).

The temporary regulations set forth the information that must be included in the qualified appraisal. Several commentators pointed out that the appraiser may be a nonresident alien who is not required to obtain a taxpayer identification number. Therefore, the final regulations have been revised to provide that the appraiser's taxpayer identification number must be provided only if the appraiser is otherwise required to obtain such a number.

Several commentators requested that the appraiser not be held accountable for the accuracy of information about the donated property provided by the donor. This suggestion has not been incorporated into the final regulations because such information affects the value of the property, and, therefore, its validity must be verified by the appraiser.

A separate qualified appraisal is required for each item of property that is not included in a group of similar items of property. Only one qualified appraisal is required for a group of similar items of property contributed in the same taxable year, provided the appraisal includes all the required information for each item. However, the appraiser may select any items whose aggregate value is appraised at $100 or less for which a group description rather than a specific description of each item will suffice.

APPRAISAL SUMMARY

The appraisal summary must be made on the form prescribed by the Internal Revenue Service, signed and dated by the original donee and qualified appraiser, and attached to the donor's return on which a deduction with respect to the appraised property is first claimed or reported. The final regulations set forth the information that must be included on the appraisal summary.

One commentator suggested that the final regulations provide an exception to the donee signature requirement in appropriate situations when the donor is unable to obtain the donee's signature. In response to the comment, §1.170A-13(c)(4)(iv)(C) provides that, in rare and unusual cases where it is not possible to obtain the donee's signature, the taxpayer's deduction will not be disallowed for that reason. An appropriate explanation should be attached to the appraisal summary.

A separate appraisal summary for each item of contributed property must be attached to the donor's return. If, however, similar items of property are contributed to the same donee, a single appraisal summary may be attached with respect to all similar items of property contributed to the same donee provided that the appraisal summary provides all the required information with respect to each item. However, the appraiser may select any items whose aggregate value is appraised at $100 or less for which a group description will suffice. A donor who contributes similar items of property to more than one donee must attach a separate appraisal summary for each donee.

The final regulations provide that every donor who presents an appraisal summary to a donee for signature after June 6, 1988, must furnish a copy of the appraisal summary to the donee. If the donor is a partnership or S corporation, the donor must provide a copy of the appraisal summary to every partner or shareholder who receives an allocation of a deduction for a charitable contribution of property described in the appraisal summary. The partner or shareholder must attach the appraisal summary to the partner's or shareholder's return. If a donor (or partner or shareholder of a donor) fails to attach the appraisal summary to the return, a charitable deduction will not be disallowed if the donor (or partner or shareholder) submits an appraisal summary within 90 days of being requested to do so by the Internal Revenue Service, provided that the failure to attach the appraisal summary was a good faith omission and the requirements of §1.170A-13(c)(3) and (4) are met (including the timely completion of the appraisal).

QUALIFIED APPRAISER

The definition of the term "qualified appraiser" is important because a donor who fails to use such an appraiser will not be entitled to a deduction with respect to a charitable contribution of property valued in excess of $5,000. Section 155 of the 1984 Act left the definition of the term qualified appraiser largely to these regulations.

Various appraisers and appraisal groups have commented that the definition of the term qualified appraiser should ensure that only individuals with specific professional standards be permitted to prepare qualified appraisals. Several commentators, for example, recommended that a qualified appraiser be defined as someone who has completed a rigid program of education, testing, and certification through a recognized professional appraisal organization which self-regulates its members.

Other commentators recommended that a designation by one of several specified professional appraisal associations should establish conclusively that a person is a qualified appraiser. Several commentators suggested that the Internal Revenue Service establish a roll of qualified appraisers that would be filled through an examination or application process.

While the interest of appraisal groups (and the Internal Revenue Service) in ensuring that only truly qualified persons be permitted to prepare qualified appraisals is strong, other competing interests also exist. In particular, donors and donees have an interest in assuring that the definition of qualified appraiser provides reasonable certainty and objectivity to persons who contemplate a charitable contribution of property expected to be valued in excess of $5,000.

After careful consideration of the recommendations received and concerns expressed, the regulations define a qualified appraiser as an individual who includes on the appraisal summary a declaration that:

(A) The individual either holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;

(B) Because of the appraiser's qualifications as described in the appraisal, the appraiser is qualified to make appraisals of the type of property being valued;

(C) The appraiser is not one of the persons that the final regulations exclude from being a qualified appraiser; and

(D) The appraiser understands that an intentionally false or fraudulent overstatement of the value of the property described in the qualified appraisal or appraisal summary may subject the appraiser to a civil penalty under section 6701 for aiding and abetting an understatement of tax liability, and, moreover, the appraiser may have appraisals disregarded pursuant to 31 U.S.C. §330(c).

Even if the individual complies with the requirements described above, the individual is not a qualified appraiser if the donor had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property. In no case is an appraiser a qualified appraiser if the appraiser is the donor, taxpayer, donee, employee of any of the foregoing or other person identified in §1.170A-13(c)(5)(iv) of the final regulations.

Several commentators suggested that a state employee who makes appraisals of contributions made to the state should not be disqualified. Section 155 of the 1984 Act explicitly provides, however, that an employee of the donee cannot be a qualified appraiser. Hence, the final regulations do not permit an employee of a state to act as a qualified appraiser of gifts to the state.

More than one appraiser may appraise the donated property provided that each appraiser complies with the requirements of this Treasury decision, including signing the qualified appraisal and appraisal summary. In response to a request for clarification, the final regulations provide that, if more than one appraiser appraises the property, the donor does not have to use each appraiser's appraisal for purposes of substantiating the deduction.

APPRAISAL FEE

Generally, no part of the fee arrangement for a qualified appraisal can be based on a percentage (or set of percentages) of the appraised value of the property. If a fee arrangement is based in whole or in part on the amount of the appraised value of the property, if any, that is allowed as a deduction under section 170, after Internal Revenue Service examination or otherwise, it shall be treated as a fee based on a percentage of the appraised value of the property. This provision does not apply in certain circumstances to appraisal fees paid to a generally recognized association that regulates appraisers. Although many commentators objected to this exception, its inclusion in the regulations is mandated by section 155(a) of the 1984 Act.

SIMILAR ITEMS OF PROPERTY

The final regulations define the phrase "similar items of property" to mean property of the same generic category or type, including stamp collections, coin collections, lithographs, paintings, photographs, books, nonpublicly traded stock, nonpublicly traded securities other than nonpublicly traded stock, land, buildings, clothing, jewelry, furniture, electronic equipment, household appliances, toys, everyday kitchenware, china, crystal, or silver.

DONEE

Several commentators questioned whether, in the case of property placed in trust for the benefit of a tax-exempt organization, the trust or the tax-exempt organization is considered to be the donee. In response to the comments, the final regulations prospectively define the term donee to mean the trust in such a case. See §1.170A-13(c)(7)(v)(C) for the rule in effect for past periods. In addition, see §1.170A-13(c)(7)(v), (vi), and (vii) for definitions of donee, original donee and successor donee, respectively.

PUBLICLY TRADED SECURITIES

The temporary regulations defined the term publicly traded securities to mean securities for which market quotations are readily available on an established securities market. The final regulations provide that market quotations are readily available on an established securities market for a security if (1) the security is listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations are published on a daily basis, including foreign securities, listed on a recognized foreign, national, or regional exchange, (2) the security is regularly traded in the national or regional over-the-counter market for which published quotations are available, or (3) the security is a share of an open-end investment company (commonly known as a mutual fund) for which quotations are published on a daily basis in a newspaper of general circulation throughout the United States. One commentator was concerned that this definition does not include bonds for which quotations of interest, but not bid or asked quotations, are listed daily in the "Yellow Sheets." In response to the comment, the Service issued Announcement 86-4, 1986-4 I.R.B. 51, which states that final regulations will provide that market quotations for an issue of a security are considered to be readily available on an established securities market for a computational period if certain requirements are met. These rules are contained in §1.170A-13(c)(7)(xi)(B) of the final regulations.

Section 1.170A-13(c)(7)(xi)(C) clarifies that securities that are otherwise publicly traded are not considered to be publicly traded if the securities are subject to restrictions of the amount claimed as a deduction with respect to the contribution of such securities is different than the amount listed in market quotations that are readily available on an established securities market.

INFORMATION RETURN BY DONEES

The final regulations provide that a donee of any charitable deduction property who sells, exchanges, consumes or otherwise disposes of the property within 2 years after the date of the donor's contribution of such property must make an information return. This rule applies to property for which the donee signs an appraisal summary either before or after disposing of the property. It also applies prospectively to a disposition made by a successor donee of the property (see §1.6050L-1(c)).

Several commentators stated that tracking an item of charitable deduction property with a *de minimis* value from the time of contribution until the time of disposition would be very burdensome. In response to the comments, the Service issued News Release IR 85-121 with accompanying Announcement 86-1, 1986-1 I.R.B. 35, on December 20, 1985. The Announcement states that final regulation will provide that donee reporting is not required with respect to an item of charitable deduction property disposed of by sale if the appraisal summary signed by a donee with respect to the item contains, at the time of the donee's signature, a statement signed by the donor that the appraised value of the item does not exceed $500. The rule is contained in §1.6050L-1(a)(2)(i) of the final regulations. For purposes of this rule items that form a set (such as, for example, a collection of books written by the same author, components of a stereo system, or a group of place settings of a pattern of silverware) are considered one item. In addition, all nonpublicly traded stock is considered one item as are all nonpublicly traded securities other than nonpublicly traded stock. The final regulations also provide that donee reporting is not required with respect to an item of charitable deduction property consumed or distributed by a donee without consideration if the consumption or distribution is in furtherance of a purpose or function constituting a basis for such donee's exemption under section 501 of the Code.

CHARITABLE DEDUCTION PROPERTY

Charitable deduction property is defined as any property (other than money and certain publicly traded securities) contributed after December 31, 1984, with respect to which the donee signs an appraisal summary. If the donee signs an appraisal summary with respect to donated property after the date of contribution, the property is deemed to be charitable deduction property from the date of contribution.

TIME FOR FILING INFORMATION

In response to comments that the requirement to file the donee information return within 90 days of the disposition of the charitable deduction property is too burdensome, the 90-day requirement has been replaced with a 125-day requirement in the final regulations. A special rule is provided in the case of a donee who has no reason to believe that the substantiation requirements of §1.170A-13(c) apply with respect to the disposed of property.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. Although a notice of proposed rulemaking that solicited public comment was issued, the Internal Revenue Service concluded when the notice was issued that the regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, the final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6). The reporting requirements added by this document have been submitted to the Office of Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduction Act of 1980. The reporting requirements have been approved by OMB (control number 1545-0908).

* * * * *

Adoption of amendments to the regulations.

Accordingly, 26 CFR Parts 1 and 602 are amended as follows:

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. * * * Section 1.170A-13 also issued under 26 U.S.C. 170 and section 155 of the Deficit Reduction Act of 1984 (98

Stat. 691). Section 1.6050L-1 also issued under 26 U.S.C. 6050L.

Par. 2. Section 1.170A-13T is removed.

Par. 3. In §1.170A-13, paragraphs (b)(1) and (b)(3)(i)(B) are revised to read as follows, and the heading and text for paragraph (c) are added.

§1.170A-13 Recordkeeping and return requirements for deductions for charitable contributions.

* * * * *

(b) *Charitable contributions of property other than money made in taxable years beginning after December 31, 1982*—(1) *In general.* Except in the case of certain charitable contributions of property made after December 31, 1984, to which paragraph (c) of this section applies, any taxpayer who makes a charitable contribution of property other than money in a taxable year beginning after December 31, 1982, shall maintain for each contribution a receipt from the donee showing the following information:

(i) The name of the donee.

(ii) The date and location of the contribution.

(iii) A description of the property in detail reasonably sufficient under the circumstances. Although the fair market value of the property is one of the circumstances to be taken into account in determining the amount of detail to be included on the receipt, such value need not be stated on the receipt.

A letter or other written communication from the donee acknowledging receipt of the contribution, showing the date of the contribution, and containing the required description of the property contributed constitutes a receipt for purposes of this paragraph. A receipt is not required if the contribution is made in circumstances where it is impractical to obtain a receipt (*e.g.*, by depositing property at a charity's unattended drop site). In such cases, however, the taxpayer shall maintain reliable written records with respect to each item of donated property that include the information required by paragraph (b)(2)(ii) of this section.

* * * * *

(3) *Deductions in excess of $500 claimed for a charitable contribution of property other than money*—(i) *In general.* ***

* * * * *

(B) The cost or other basis, adjusted as provided by section 1016, of property, other than publicly traded securities, held by the taxpayer for a period of less than 12 months (6 months for property contributed in taxable years beginning after December 31, 1982, and on or before June 6, 1988) immediately preceding the date on which the contribution was made and, when the information is available, of property, other than publicly traded securities, held for a period of 12 months or more (6 months or more for property contributed in taxable years beginning after December 31, 1982, and on or before June 6, 1988) preceding the date on which the contribution was made.

* * * * *

(c) *Deductions in excess of $5,000 for certain charitable contributions of property made after December 31, 1984*—(1) *General Rule*—(i) *In general.* This paragraph applies to any charitable contribution made after December 31, 1984, by an individual, closely held corporation, personal service corporation, partnership, or S corporation of an item of property (other than money and publicly traded securities to which §1.170A-13(c)(7)(xi)(B) does not apply) if the amount claimed or reported as a deduction under section 170 with respect to such item exceeds $5,000. This paragraph also applies to charitable contributions by C corporations (as defined in section 1361(a)(2) of the Code) to the extent described in paragraph (c)(2)(ii) of this section. No deduction under section 170 shall be allowed with respect to a charitable contribution to which this paragraph applies unless the substantiation requirements described in paragraph (c)(2) of this section are met. For purposes of this paragraph (c), the amount claimed or reported as a deduction for an item of property is the aggregate amount claimed or reported as a deduction for a charitable contribution under section 170 for such items of property and all similar items of property (as defined in paragraph (c)(7)(iii) of this section) by the same donor for the same taxable year (whether or not donated to the same donee).

(ii) *Special rule for property to which section 170(e)(3) or (4) applies.* For purposes of this paragraph (c), in computing the amount claimed or reported as a deduction for donated property to which section 170(e)(3) or (4) applies (pertaining to certain contributions of inventory and scientific equipment) there shall be taken into account only the amount claimed or reported as a deduction in excess of the amount which would have been taken into account for tax purposes by the donor as costs of goods sold if the donor had sold the contributed property to the donee. For example, assume that a donor makes a contribution from inventory of clothing for the care of the needy to which section 170(e)(3) applies. The cost of the property to the donor was $5,000, and, pursuant to section 170(e)(3)(B), the donor claims a charitable contribution deduction of $8,000 with respect to the property. Therefore, $3,000 ($8,000-$5,000) is the amount taken into account for purposes of determining whether the $5,000 threshold of this paragraph (c)(1) is met.

(2) *Substantiation requirements*—(i) *In general.* Except as provided in paragraph (c)(2)(ii) of this section, a donor who claims or reports a deduction with respect to a charitable contribution to which this paragraph (c) applies must comply with the following three requirements:

(A) Obtain a qualified appraisal (as defined in paragraph (c)(3) of this section) for such property contributed. If the contributed property is a partial interest, the appraisal shall be of the partial interest.

(B) Attach a fully completed appraisal summary (as defined in paragraph (c)(4) of this section) to the tax return (or, in the case of a donor that is a partnership or S corporation, the information return) on which the deduction for the contribution is first claimed (or reported) by the donor.

(C) Maintain records containing the information required by paragraph (b)(2)(ii) of this section.

(ii) *Special rules for certain nonpublicly traded stock, certain publicly traded securities, and contributions by certain C corporations.* (A) In cases described in paragraph (c)(2)(ii)(B) of this section, a qualified appraisal is not required, and only a partially completed appraisal summary form (as described in paragraph (c)(4)(iv)(A) of this section) is required to be attached to the tax or information return specified in paragraph (c)(2)(i)(B) of this section. However, in all cases donors must maintain records containing the information required by paragraph (b)(2)(ii) of this section.

(B) This paragraph (c)(2)(ii) applies in each of the following cases:

(*1*) The contribution of nonpublicly traded stock, if the amount claimed or reported as a deduction for the charitable contribution of such stock is greater than $5,000 but does not exceed $10,000;

(*2*) The contribution of a security to which paragraph (c)(7)(xi)(B) of this section applies; and

(*3*) The contribution of an item of property or of similar items of property described in paragraph (c)(1) of this section made after June 6, 1988, by a C corporation (as defined in section 1361(a)(2) of the Code), other than a closely held corporation or a personal service corporation.

(3) *Qualified appraisal*—(i) *In general.* For purposes of this paragraph (c), the term "qualified appraisal" means an appraisal document that—

(A) Relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property nor later than the date specified in paragraph (c)(3)(iv)(B) of this section;

(B) Is prepared, signed, and dated by a qualified appraiser (within the meaning of paragraph (c)(5) of this section);

(C) Includes the information required by paragraph (c)(3)(ii) of this section; and

(D) Does not involve an appraisal fee prohibited by paragraph (c)(6) of this section.

(ii) *Information included in qualified appraisal.* A qualified appraisal shall include the following information:

(A) A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed;

(B) In the case of tangible property, the physical condition of the property;

(C) The date (or expected date) of contribution to the donee;

(D) The terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the donor or donee that relates to the use, sale, or other disposition of the property contributed, including, for example, the terms of any agreement or understanding that—

(*1*) Restricts temporarily or permanently a donee's right to use or dispose of the donated property,

(*2*) Reserves to, or confers upon, anyone (other than a donee organization or an organization participating with a donee organization in cooperative fund-raising) any right to the income from the contributed property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire, or

(*3*) Earmarks donated property for a particular use;

(E) The name, address, and (if a taxpayer identification number is otherwise required by section 6109 and the regulations thereunder) the identifying number of the qualified appraiser; and, if the qualified appraiser is acting in his or her capacity as a partner in a partnership, an employee of any person (whether an individual, corporation, or partnerships), or an independent contractor engaged by a person other than the donor, the name, address, and taxpayer identification number (if a number is otherwise required by section 6109 and the regulations thereunder) of the partnership or the person who employs or engages the qualified appraiser;

(F) The qualifications of the qualified appraiser who signs the appraisal, including the appraiser's background, experience, education, and membership, if any, in professional appraisal associations;

(G) A statement that the appraisal was prepared for income tax purposes;

(H) The date (or dates) on which the property was appraised;

(I) The appraised fair market value (within the meaning of §1.170A-1(c)(2)) of the property on the date (or expected date) of contribution;

(J) The method of valuation used to determine the fair market value, such as the income approach, the market-data approach, and the replacement-cost-less-depreciation approach; and

(K) The specific basis for the valuation, such as specific comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.

(iii) *Effect of signature of the qualified appraiser.* Any appraiser who falsely or fraudulently overstates the value of the contributed property referred to in a qualified appraisal or appraisal summary (as defined in paragraph (c)(3) and (4), respectively, of this section) that the appraiser has signed may be subject to a civil penalty under section 6701 for aiding and abetting an understatement of tax liability and, moreover, may have appraisals disregarded pursuant to 31 U.S.C. §330(c).

(iv) *Special rules*—(A) *Number of qualified appraisals.* For purposes of paragraph (c)(2)(i)(A) of this section, a separate qualified appraisal is required for each item of property that is not included in a group of similar items of property. See paragraph (c)(7)(iii) of this section for the definition of similar items of property. Only one qualified appraisal is required for a group of similar items of property contributed in the same taxable year of the donor, although a donor may obtain separate qualified appraisals for each item of property. A qualified appraisal prepared with respect to a group of similar items of property shall provide all the information required by paragraph (c)(3)(ii) of this section for each item of similar property, except that the appraiser may select any items whose aggregate value is appraised at $100 or less and provide a group description of such items.

(B) *Time of receipt of qualified appraisal.* The qualified appraisal must be received by the donor before the due date (including extensions) of the return on which a deduction is first claimed (or reported in the case of a donor that is a partnership or S corporation) under section 170 with respect to the donated property, or, in the case of a deduction first claimed (or reported) on an amended return, the date on which the return is filed.

(C) *Retention of qualified appraisal.* The donor must retain the qualified appraisal in the donor's records for so long as it may be relevant in the administration of any internal revenue law.

(D) *Appraisal disregarded pursuant to 31 U.S.C. 330(c).* If an appraisal is disregarded pursuant to 31 U.S.C. 330(c) it shall have no probative effect as to the value of the appraised property. Such appraisal will, however, otherwise constitute a "qualified appraisal" for purposes of this paragraph (c) if the appraisal summary includes the declaration described in paragraph (c)(4)(ii)(L)(*2*) and the taxpayer had no knowledge that such declaration was false as of the time described in paragraph (c)(4)(i)(B) of this section.

(4) *Appraisal summary*—(i) *In general.* For purposes of this paragraph (c), except as provided in paragraph (c)(4)(iv)(A) of this section, the term "appraisal summary" means a summary of a qualified appraisal that—

(A) Is made on the form prescribed by the Internal Revenue Service;

(B) Is signed and dated (as described in paragraph (c)(4)(iii) of this section) by the donee (or presented to the donee for signature in cases described in paragraph (c)(4)(iv)(C)(*2*) of this section);

(C) Is signed and dated by the qualified appraiser (within the meaning of paragraph (c)(5) of this section) who prepared the qualified appraisal (within the meaning of paragraph (c)(3) of this section); and

(D) Includes the information required by paragraph (c)(4)(ii) of this section.

(ii) *Information included in an appraisal summary.* An appraisal summary shall include the following information:

(A) The name and taxpayer identification number of the donor (social security number if the donor is an individual or employer identification number if the donor is a partnership or corporation);

(B) A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was contributed;

(C) In the case of tangible property, a brief summary of the overall physical condition of the property at the time of the contribution;

(D) The manner of acquisition (*e.g.*, purchase, exchange, gift, or bequest) and the date of acquisition of the property by the donor, or, if the property was created, produced, or manufactured by or for the donor, a statement to that effect and the approximate date the property was substantially completed;

(E) The cost or other basis of the property adjusted as provided by section 1016;

(F) The name, address, and taxpayer identification number of the donee;

(G) The date the donee received the property;

(H) For charitable contributions made after June 6, 1988, a statement explaining whether or not the charitable contribution was made by means of a bargain sale and the amount of any consideration received from the donee for the contribution;

(I) The name, address, and (if a taxpayer identification number is otherwise required by section 6109 and the regulations thereunder) the identifying number of the qualified appraiser who signs the appraisal summary and of other persons as required by paragraph (c)(3)(ii)(E) of this section;

(J) The appraised fair market value of the property on the date of contribution;

(K) The declaration by the appraiser described in paragraph (c)(5)(i) of this section;

(L) A declaration by the appraiser stating that—

(*1*) The fee charged for the appraisal is not of a type prohibited by paragraph (c)(6) of this section; and

(*2*) Appraisals prepared by the appraiser are not being disregarded pursuant to 31 U.S.C. §330(c) on the date the appraisal summary is signed by the appraiser; and

(M) Such other information as may be specified by the form.

(iii) *Signature of the original donee.* The person who signs the appraisal summary for the donee shall be an official authorized to sign the tax or information returns of the donee, or a person specifically authorized to sign appraisal summaries by an official authorized to sign the tax or information returns of such donee. In the case of a donee that is a governmental unit, the person who signs the appraisal summary for such donee shall be the official authorized by such donee to sign appraisal summaries. The signature of the donee on the appraisal summary does not represent concurrence in the appraised value of the contributed property. Rather, it represents acknowledgment of receipt of the property described in the appraisal summary on the date specified in the appraisal summary that the donee understands the information reporting requirements imposed by section 6050L and §1.6050L-1. In general, §1.6050L-1 requires the donee to file an information return with the Internal Revenue Service in the event the donee sells, exchanges, consumes, or otherwise disposes of the property (or any portion thereof) described in the appraisal summary within 2 years after the date of the donor's contribution of such property.

(iv) *Special rules*—(A) *Content of appraisal summary required in certain cases.* With respect to contributions of nonpublicly traded stock described in paragraph (c)(2)(ii)(B)(*1*) of this section, contributions of securities described in paragraph (c)(7)(xi)(B) of this section, and contributions by C corporations described in paragraph (c)(2)(ii)(B)(*3*) of this section, the term "appraisal summary" means a document that—

(*1*) Complies with the requirements of paragraph (c)(4)(i)(A) and (B) of this section,

(*2*) Includes the information required by paragraph (c)(4)(ii)(A) through (H) of this section,

(*3*) Includes the amount claimed or reported as a charitable contribution deduction, and

(*4*) In the case of securities described in paragraph (c)(7)(xi)(B) of this section, also includes the pertinent average trading price (as described in paragraph (c)(7)(xi)(B)(*2*)(*iii*) of this section).

(B) *Number of appraisal summaries.* A separate appraisal summary for each item of property described in paragraph (c)(1) of this section must be attached to the donor's return. If, during the donor's taxable year, the donor contributes similar items of property described in paragraph (c)(1) of this section to more than one donee, the donor shall attach to the donor's return a separate appraisal summary for each donee. See paragraph (c)(7)(iii) of this section for the definition of similar items of property. If, however, during the donor's taxable year, a donor contributes similar items of property described in paragraph (c)(1) of this section to the same donee, the donor may attach to the donor's return a single appraisal summary with respect to all similar items of property contributed to the same donee. Such an appraisal summary shall provide all the information required by paragraph (c)(4)(ii) of this section for each item of property, except that the appraiser may select any items whose aggregate value is appraised at $100 or less and provide a group description for such items.

(C) *Manner of acquisition, cost basis and donee's signature.* (*1*) If a taxpayer has reasonable cause for being unable to provide the information required by paragraph (c)(4)(ii)(D) and (E) of this section (relating to the manner of acquisition and basis of the contributed property), an appropriate explanation should be attached to the appraisal summary. The taxpayer's deduction will not be disallowed simply because of the inability (for reasonable cause) to provide these items of information.

(*2*) In rare and unusual circumstances in which it is impossible for the taxpayer to obtain the signature of the donee on the appraisal summary as required by paragraph (c)(4)(i)(B) of this section, the taxpayer's deduction will not be disallowed for that reason provided that the taxpayer attaches a statement to the appraisal summary explaining, in detail, why it was not possible to obtain the donee's signature. For example, if the donee ceases to exist as an entity subsequent to the date of the contribution and prior to the date when the appraisal summary must be signed, and the donor acted reasonably in not obtaining the donee's signature at the time of the contribution, relief under this paragraph (c)(4)(iv)(C)(*2*) would generally be appropriate.

(D) *Information excluded from certain appraisal summaries.* The information required by paragraph (c)(4)(i)(C), paragraph (c)(4)(ii)(D), (E), (H) through (M), and paragraph (c)(4)(iv)(A)(*3*), and the average trading price referred to in paragraph (c)(4)(iv)(A)(*4*) of this section do not have to be included in the appraisal summary at the time it is signed by the donee or a copy is provided to the donee pursuant to paragraph (c)(4)(iv)(E) of this section.

(E) *Statement to be furnished by donors to donees.* Every donor who presents an appraisal summary to a donee for signature after June 6, 1988, in order to comply with paragraph (c)(4)(i)(B) of this section shall furnish a copy of the appraisal summary to such donee.

(F) *Appraisal summary required to be provided to partners and S corporation shareholders.* If the donor is a partnership or S corporation, the donor shall provide a copy of the appraisal summary to every partner or shareholder, respectively, who receives an allocation of a charitable contribution deduction under section 170 with respect to the property described in the appraisal summary.

(G) *Partners and S corporation shareholders.* A partner of a partnership or shareholder of an S corporation who receives an allocation of a deduction under section 170 for a charitable contribution of property to which this paragraph (c) applies must attach a copy of the partnership's or S corporation's appraisal summary to the tax return on which the deduction for the contribution is first claimed. If such appraisal summary is not attached, the partner's or shareholder's deduction shall not be allowed except as provided for in paragraph (c)(4)(iv)(H) of this section.

(H) *Failure to attach appraisal summary.* In the event that a donor fails to attach to the donor's return an appraisal summary as required by paragraph (c)(2)(i)(B) of this section, the Internal Revenue Service may request that the donor submit the appraisal summary within 90 days of the request. If such a request is made and the donor complies with the request within the 90-day period, the deduction under section 170 shall not be disallowed for failure to attach the appraisal summary, provided that the donor's failure to attach the appraisal summary was a good faith omission and the requirements of paragraph (c)(3) and (4) of this section are met (including the completion of the qualified appraisal prior to the date specified in paragraph (c)(3)(iv)(B) of this section).

(5) *Qualified appraiser*—(i) *In general.* The term "qualified appraiser" means an individual (other than a person described in paragraph (c)(5)(iv) of this section) who includes on the appraisal summary (described in paragraph (c)(4) of this section), a declaration that—

(A) The individual either holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;

(B) Because of the appraiser's qualifications as described in the appraisal (pursuant to paragraph (c)(3)(ii)(F) of this section), the appraiser is qualified to make appraisals of the type of property being valued;

(C) The appraiser is not one of the persons described in paragraph (c)(5)(iv) of this section; and

(D) The appraiser understands that an intentionally false or fraudulent overstatement of the value of the property described in the qualified appraisal or appraisal summary may subject the appraiser to a civil penalty under section 6701 for aiding and abetting an understatement of tax liability, and, moreover, the appraiser may have appraisals disregarded pursuant to 31 U.S.C. §330(c) (see paragraph (c)(3)(iii) of this section).

(ii) *Exception.* An individual is not a qualified appraiser with respect to a particular donation, even if the declaration specified in paragraph (c)(5)(i) of this section is provided in the appraisal summary, if the donor had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property (*e.g.*, the donor and the appraiser make an agreement concerning the amount at which the property will be valued and the donor knows that such amount exceeds the fair market value of the property).

(iii) *Numbers of appraisers.* More than one appraiser may appraise the donated property. If more than one appraiser appraises the property, the donor does not have to use each appraiser's appraisal for purposes of substantiating the charitable contribution deduction pursuant to this paragraph (c). If the donor uses the appraisal of more than one appraiser, or if two or more appraisers contribute to a single appraisal, each appraiser shall comply with the requirements of this paragraph (c), including signing the qualified appraisal and appraisal summary as required by paragraphs (c)(3)(i)(B) and (c)(4)(i)(C) of this section, respectively.

(iv) *Qualified appraiser exclusions.* The following persons cannot be qualified appraisers with respect to particular property:

(A) The donor or the taxpayer who claims or reports a deduction under section 170 for the contribution of the property that is being appraised.

(B) A party to the transaction in which the donor acquired the property being appraised (*i.e.*, the person who sold, exchanged, or gave the property to the donor, or any person who acted as an agent for the transferor or for the donor with respect to such sale, exchange, or gift), unless the property is donated within 2 months of the date of acquisition and its appraised value does not exceed its acquisition price.

(C) The donee of the property.

(D) Any person employed by any of the foregoing persons (*e.g.*, if the donor acquired a painting from an art dealer, neither the art dealer nor persons employed by the dealer can be qualified appraisers with respect to that painting).

(E) Any person related to any of the foregoing persons under section 267(b), or, with respect to appraisals made after June 6, 1988, married to a person who is in a relationship described in section 267(b) with any of the foregoing persons.

(F) An appraiser who is regularly used by any person described in paragraph (c)(5)(iv)(A), (B), or (C) of this section and who does not perform a majority of his or her appraisals made during his or her taxable year for other persons.

(6) *Appraisal fees*—(i) *In general.* Except as otherwise provided in paragraph (c)(6)(ii) of this section, no part of the fee arrangement for a qualified appraisal can be based, in effect, on a percentage (or set of percentages) of the appraised value of the property. If a fee arrangement for an appraisal is based in whole or in part on the amount of the appraised value of the property, if any, that is allowed as a deduction under section 170, after Internal Revenue Service examination or otherwise, it shall be treated as a fee based on a percentage of the appraised value of the property. For example, an appraiser's fee that is subject to reduction by the same percentage as the appraised value may be reduced by the Internal Revenue Service would be treated as a fee that violates this paragraph (c)(6).

(ii) *Exception.* Paragraph (c)(6)(i) of this section does not apply to a fee paid to a generally recognized association that regulates appraisers provided all of the following requirements are met:

(A) The association is not organized for profit and no part of the net earnings of the association inures to the benefit of any private shareholder or individual (these terms have the same meaning as in section 501(c)),

(B) The appraiser does not receive any compensation from the association or any other persons for making the appraisal, and

(C) The fee arrangement is not based in whole or in part on the amount of the appraised value of the donated property, if any, that is allowed as a deduction under section 170 after Internal Revenue Service examination or otherwise.

(7) *Meaning of terms.* For purposes of this paragraph (c)—

(i) *Closely held corporation.* The term "closely held corporation" means any corporation (other than an S corporation) with respect to which the stock ownership requirement of paragraph (2) of section 542(a) of the Code is met.

(ii) *Personal service corporation.* The term "personal service corporation" means any corporation (other than an S corporation) which is a service organization (within the meaning of section 414(m)(3) of the Code).

(iii) *Similar items of property.* The phrase "similar items of property" means property of the same generic category or type, such as stamp collections (including philatelic supplies and books on stamp collecting), coin collections (including numismatic supplies and books on coin collecting), lithographs, paintings, photographs, books, nonpublicly traded stock, nonpublicly traded securities other than nonpublicly traded stock, land, buildings, clothing, jewelry, furniture, electronic equipment, household appliances, toys, everyday kitchenware, china, crystal, or silver. For example, if a donor claims on her return for the year deductions of $2,000 for books given by her to College A, $2,500 for books given by her to College B, and $900 for books given by her to College C, the $5,000 threshold of paragraph (c)(1) of this section is exceeded. Therefore, the donor must obtain a qualified appraisal for the books and attach to her return three appraisal summaries for the books donated to A, B, and C. For rules regarding the number of qualified appraisals and appraisal summaries required when similar items of property are contributed, see paragraphs (c)(3)(iv)(A) and (c)(4)(iv)(B), respectively, of this section.

(iv) *Donor.* The term "donor" means a person or entity (other than an organization described in section 170(c) to which the donated property was previously contributed) that makes a charitable contribution of property.

(v) *Donee.* The term "donee" means—

(A) Except as provided in paragraph (c)(7)(v)(B) and (C) of this section, an organization described in section 170(c) to which property is contributed,

(B) Except as provided in paragraph (c)(7)(v)(C) of this section, in the case of a charitable contribution of property placed in trust for the benefit of an organization described in section 170(c), the trust, or

(C) In the case of a charitable contribution of property placed in trust for the benefit of an organization described in section 170(c) made on or before June 6, 1988, the beneficiary that is an organization described in section 170(c), or if the trust has assumed the duties of a donee by signing the appraisal summary pursuant to paragraph (c)(4)(i)(B) of this section, the trust.

In general, the term refers only to the original donee. However, with respect to paragraph (c)(3)(ii)(D), the last sentence of paragraph (c)(4)(iii), and paragraph (c)(5)(iv)(C) of this section, the term "donee" means the original donee and all successor donees in cases where the original donee transfers the contributed property to a successor donee after July 5, 1988.

(vi) *Original donee.* The term "original donee" means the donee to or for which property is initially donated by a donor.

(vii) *Successor donee.* The term "successor donee" means any donee of property other than its original donee (*i.e.*, a transferee of property for less than fair market value from an original donee or another successor donee).

(viii) *Fair market value.* For the meaning of the term "fair market value," see section 1.170A-1(c)(2).

(ix) *Nonpublicly traded securities.* The term "nonpublicly traded securities" means securities (within the meaning of section 165(g)(2) of the Code) which are not publicly traded securities as defined in paragraph (c)(7)(xi) of this section.

(x) *Nonpublicly traded stock.* The term "nonpublicly traded stock" means any stock of a corporation (evidence by a stock certificate) which is not a publicly traded security. The term stock does not include a debenture or any other evidence of indebtedness.

(xi) *Publicly traded securities*—(A) *In general.* Except as provided in paragraph (c)(7)(xi)(C) of this section, the term "publicly traded securities" means securities (within the meaning of section 165(g)(2) of the Code) for which (as of the date of the contribution) market quotations are readily available on an established securities market. For purposes of this section, market quotations are readily available on an established securities market with respect to a security if:

(*1*) The security is listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations are published on a daily basis, including foreign securities listed on a recognized foreign, national, or regional exchange in which quotations are published daily basis;

(*2*) The security is regularly traded in the national or regional over-the-counter market, for which published quotations are available; or

(*3*) The security is a share of an open-end investment company (commonly known as a mutual fund) registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 to 80b-2), for which quotations are published on a daily basis in a newspaper of general circulation throughout the United States.

(If the market value of an issue of a security is reflected only on an interdealer quotation system, the issue shall not be considered to be publicly traded unless the special rule described in paragraph (c)(7)(xi)(B) of this section is satisfied.)

(B) *Special rule*—(*1*) *In General.* An issue of a security that does not satisfy the requirements of paragraph (c)(7)(xi)(A)(*1*), (*2*), or (*3*) of this section shall nonetheless be considered to have market quotations readily available on an established securities market for purposes of paragraph (c)(7)(xi)(A) of this section if all of the following five requirements are met:

(*i*) The issue is regularly traded during the computational period (as defined in paragraph (c)(7)(xi)(B)(*2*)(*iv*) of this section) in a market that is reflected by the existence of an interdealer quotation system for the issue,

(*ii*) The issuer or an agent of the issuer computes the average trading price (as defined in paragraph (c)(7)(xi)(B)(*2*)(*iii*) of this section) for the issue for the computational period,

(*iii*) The average trading price and total volume of the issue during the computational period are published in a newspaper of general circulation throughout the United States not later than the last day of the month following the end of the calendar quarter in which the computational period ends,

(*iv*) The issuer or its agent keeps books and records that list for each transaction during the computational period involving each issue covered by this procedure the date of the settlement of the transaction, the name and address of the broker or dealer making the market in which the transaction occurred, and the trading price and volume, and

(*v*) The issuer or its agent permits the Internal Revenue Service to review the books and records described in paragraph (c)(7)(xi)(B)(*1*)(*iv*) of this section with respect to transactions during the computational period upon giving reasonable notice to the issuer or agent.

(*2*) *Definitions.* For purposes of this paragraph (c)(7)(xi)(B)—

(*i*) *Issue of a security.* The term "issue of a security" means a class of debt securities with the same obligor and identical terms except as to their relative denominations (amounts) or a class of stock having identical rights.

(*ii*) *Interdealer quotation system.* The term "interdealer quotation system" means any system of general circulation to brokers and dealers that regularly disseminates quotations of obligations by two or more identified brokers or dealers, who are not related to either the issuer of the security or to the issuer's agent, who compute the average trading price of the security. A quotation sheet prepared and distributed by a broker or dealer in the regular course of its business and containing only quotations of such broker or dealer is not an interdealer quotation system.

(*iii*) *Average trading price.* The term "average trading price" means the mean price of all transactions (weighted by volume), other than original issue or redemption transactions, conducted through a United States office of a broker or dealer who maintains a market in the issue of the security during the computational period. For this period, bid and asked quotations are not taken into account.

(*iv*) *Computational period.* For calendar quarters beginning on or after June 6, 1988, the term "computational period" means weekly during October through December (beginning with the first Monday in October and ending with the first Sunday following the last Monday in December) and monthly during January through September (beginning January 1). For calendar quarters beginning before June 6, 1988, the term "computational period" means weekly during October through December and monthly during January through September.

(C) *Exception.* Securities described in paragraph (c)(7)(xi)(A) or (B) of this section shall not be considered publicly traded securities if—

(*1*) The securities are subject to any restrictions that materially affect the value of the securities to the donor or prevent the securities from being freely traded, or

(*2*) If the amount claimed or reported as a deduction with respect to the contribution of the securities is different than the amount listed in the market quotations that are readily available on an established securities market pursuant to paragraph (c)(7)(xi)(A) or (B) of this section.

(D) *Market quotations and fair market value.* The fair market value of a publicly traded security, as defined in this paragraph (c)(7)(xi), is not necessarily equal to its market quotation, its average trading price (as defined in paragraph (c)(7)(xi)(B)(*2*)(*iii*) of this section), or its face value, if any. See section 1.170A-1(c)(2) for the definition of "fair market value."

Par. 4. Paragraph (i) of §.170A-14 is amended by removing from the last sentence "§1.170A-13T(c)" and adding in its place "§1.170A-13(c)".

Par. 5. Section 1.6050L-1T is removed.

Par. 6. A new §1.6050L-1 is added immediately after §1.6050K-1 to read as follows:

§1.6050L-1 Information return by donees relating to certain dispositions of donated property.

(a) *Information returns*—(1) *Disposition of charitable deduction property.* If a donee of any charitable deduction property (as defined in paragraph (e) of this section) sells, exchanges, consumes, or otherwise disposes of (with or without consideration) such property (or any portion thereof) within 2 years after the date of the donor's contribution of such property, the donee shall make an information return on the form prescribed by the Internal Revenue Service. For special rules with respect to successor donees, see paragraph (c) of this section.

(2) *Disposition of items appraised for $500 or less*—(i) *In general.* Paragraph (a)(1) of this section shall not apply with respect to an item of charitable deduction property disposed of by sale if the appraisal summary (as defined in §1.170A-13(c)(4)) signed by the donee with respect to the item contains, at the time of the donee's signature, a statement signed by the donor that the appraised value of the item does not exceed $500. In the case of an appraisal summary that describes more than one item, this exception shall apply only with respect to an item clearly identified as having an appraised value of $500 or less. For purposes of this paragraph (a)(2)(i), items that form a set (such as, for example, a collection of books written by the same author, components of a stereo system, or a group of place settings of a pattern of silverware) are considered one item. In addition, all nonpublicly traded stock is considered one item as are all nonpublicly traded securities other than nonpublicly traded stock.

(ii) *Transitional rule.* Paragraph (a)(2)(i) of this section is satisfied with respect to an appraisal summary submitted to the donee on or before January 31, 1986, if such donee obtained the required statement from the donor on or before March 31, 1986, on either an amended appraisal summary or an attachment to the original appraisal summary.

(3) *Consumption or distribution for exempt purpose.* Paragraph (a)(1) of this section shall not apply with respect to an item of charitable deduction property consumed or distributed by a donee without consideration if the consumption or distribution is in furtherance of a purpose or function constituting a basis for such donee's exemption under section 501 of the Code. For example, no reporting is required with respect to medical supplies consumed or distributed by a tax-exempt relief organization in aiding disaster victims.

(b) *Information required to be provided on return.* The information return required by paragraph (a)(1) of this section shall include the following:

(1) The name, address, and employer identification number of the donee making the information return;

(2) A description of the property (or portion disposed of) in sufficient detail to identify the charitable deduction property received by such donee;

(3) The name and taxpayer identification number of the donor (social security number if the donor is an individual or employer identification number if the donor is a corporation or partnership);

(4) The date of the contribution to such donee;

(5) Any amount received by such donee with respect to the disposition;

(6) The date of the disposition by such donee; and

(7) Such other information as may be specified by the form or its instructions.

(c) *Successor donees*—(1) *In general.* Section 6050L and this section shall apply to successor donees that receive charitable deduction property (as defined in paragraph (e) of this section) that was transferred by the original donee after July 6, 1988, whether the successor donee received the property from the original donee or another successor donee). For definitions of the term "donor," "donee," "original donee," and "successor donee," see §1.170A-13(c)(7)(iv)-(vii).

(2) *Information required to be provided on return.* With respect to charitable deduction property that is transferred to one or more successor donees to which this section applies, the information return required by paragraph (a)(1) of this section shall include, in addition to the information described in paragraph (b) of this section, the following:

(i) The name, address, and employer identification number of the immediately succeeding successor donee (if any) and the immediately preceding successor donee (if any);

(ii) The name, address, and employer identification number of the original donee if different from the information required by paragraph (b)(1) of this section;

(iii) The date of contribution to the original donee; and

(iv) Such other information as may be specified by the form or its instructions.

(3) *Information to be provided to transferor.* Every successor donee to which this section applies that receives any charitable deduction property within the 2-year period described in paragraph (a)(1) of this section shall provide its name, address, and employer identification number to that preceding donee on or before the 15th day after the later of—

(i) The date of transfer to such successor donee, or

(ii) The date such successor donee receives a copy of the appraisal summary from the preceding donee.

(4) *Donees that transfer property to successor donees.* In addition to complying with the requirements of paragraph (a)(1) of this section, every donee that transfers any charitable deduction property to a successor donee to which this section applies within the 2-year period described in paragraph (a)(1) of this section—

(i) Shall provide its name, address, and employer identification number and copy of the appraisal summary (as described in §1.170A-13(c)(4)) relating to the transferred property to the successor donee on or before the 15th day after the latest of—

(A) The date of such transfer, or

(B) The date the original donee signs the appraisal summary, or

(C) In a case in which the transferring donee is a successor donee, the date such donee receives a copy of the appraisal summary from such donee's transferor, and

(ii) Shall provide a copy of its information return required by paragraph (a)(1) this section to the successor donee on or before the 15th day after the transferring donee files the information return pursuant to paragraph (e)(2) of this section.

(5) *Donee.* In the case of charitable deduction property that is transferred to a successor donee to which this section applies, the term "donee" as used in paragraph (a)(2) and (e) of this section means only the original donee.

(d) *Special rules*—(1) *Statement to be furnished to donors.* Every donee making a return under section 6050L and this section with respect to the disposition of charitable deduction property shall furnish a copy of the return to the donor of the property.

(2) *Retention of appraisal summary.* Every donee shall retain the appraisal summary described in §1.170A-13(c)(4) in the donee's records for so long as it may be relevant in the administration of any internal revenue law.

(e) *Charitable deduction property.* For purposes of this section, the term "charitable deduction property" means any property (other than money and publicly traded securities to which §1.170A-13(c)(7)(xi)(B) does not apply) contributed after December 31, 1984, with respect to which the donee signs (or is presented with for signature in cases described in §1.170A-13(c)(4)(iv)(C)(*2*)) an appraisal summary (as required by §1.170A-13(c)(4)(i)(B)). For purposes of this section, if such donee signs (or is presented with for signature in cases described in §1.170A-13(c)(4)(iv)(C)(*2*)) the appraisal summary after the date of contribution of the property, the property is deemed to be charitable deduction property from the date of contribution.

(f) *Place and time for filing information returns*—(1) *Place for filing.* The donee information return required by section 6050L and this section shall be filed with the Internal Revenue Service center listed on the return form or its instructions.

(2) *Time for filing*—(i) *In general.* Except as provided in paragraph (f)(2)(ii) of this section, the donee information return shall be filed on or before the 125th day after a donee sells, exchanges, consumes or otherwise disposes of the charitable deduction property. A donee information return filed pursuant to this paragraph (f)(2)(i) does not have to include the information required by paragraphs (b)(3), (4), (5), or (6), or (c)(2)(i)-(iii) of this section if such information is not available to the donee by the due date of the return.

(ii) *Exception.* Notwithstanding paragraph (f)(2)(i) of this section, in the case of a donee who, on the date of receipt of the transferred property, had no reason to believe that the substantiation requirements of §1.170A-13(c) apply with respect to the property, the donee information return is not required to be filed until the 60th day after the later of May 5, 1988, or the date on which such donee has reason to believe that the substantiation requirements of §1.170A-13(c) apply with respect to the property. A donee information return filed pursuant to this paragraph (f)(2)(ii) does not have to include the information required by paragraphs (b)(3), (4), (5), or (6), or (c)(2)(i)-(iii) of this section if such information is not available to the donee by the due date of the return.

(g) *Penalties.* For penalties for failure to comply with the requirements of this section, see sections 6676, 6721, and 6723.

OMB CONTROL
NUMBERS UNDER THE
PAPERWORK
REDUCTION ACT
(26 CFR Part 602)

Par. 5. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 6. Paragraph (c) of §602.101 is amended by inserting in the appropriate place in the table "§1.170A-13(c). . .1545-0908" and "§1.6050L-1. . .1545-0908".

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved April 19, 1988.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on May 4, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 5, 1988, 53 F.R. 16076)

Part VII.—Additional Itemized Deductions for Individuals

Section 212.—Expenses For Production of Income

26 CFR 1.212-1: Nontrade or nonbusiness expenses.

The fee paid by a syndicated limited partnership for the tax opinion used in the partnership's prospectus is a syndication expense chargeable by the partnership to a capital account and can not be amortized. See Rev. Rul. 88-4, page 264.

Section 217.—Moving Expenses

26 CFR 1.217-2: Deduction for moving expenses paid or incurred in taxable years beginning after December 31, 1969.

Moving expenses; U.S. Government employee. The transfer of a U.S. Government employee is not a transfer within the meaning of section 217(d)(1)(B) of the Code if the employee initiates the transfer even if the transfer is in the interest of the government.

Rev. Rul. 88-47

ISSUE

If a transfer of a U.S. government employee is determined to be in the interest of the government and not primarily for the convenience or benefit of the employee or at the employee's request and, based on this determination, the employee's moving expenses are reimbursed, is the transfer necessarily "for the benefit of an employer" within the meaning of section 217(d)(1)(B) of the Internal Revenue Code?

FACTS

During 1986, *A*, an individual, was employed by *L*, a private company. On January 2, 1987, *A* commenced employment with *M*, an agency of the U.S. government located in a different part of the country from where *L* was located. On *A*'s 1986 federal income tax return, deductions were claimed for moving expenses associated with the move from employer *L* to employer *M*. None of *A*'s costs associated with this move were reimbursed by *M*.

When *A* commenced employment with *M*, *A* expected to remain employed in that position indefinitely. However, on April 1, 1987, *A* applied for another position with *M* in response to a vacancy announcement posted by *M* under its merit promotion program. *M* subsequently offered the position to *A*, and on July 1, 1987, *A* accepted the offer. The new position was not located in the same part of the country as *A*'s original position with *M*. In connection with the change of positions, *M* reimbursed *A* for a portion of *A*'s travel, transportation, and relocation expenses. The reimbursement was made pursuant to 5 U.S.C. sections 5724, 5724a, 5724b, and 5724c (1987). Such reimbursement is authorized only if the employing agency determines that the transfer is in the interest of the government and is not made primarily for the convenience or benefit of the employee or at the employee's request. *See* 5 U.S.C. section 5724(h) and paragraph 2-1.3, Federal Travel Regulations, FPMR 101-7 (March 13, 1984). *See also Eugene R. Platt*, 61 Comp. Gen. 156 (1981), and 59 Comp. Gen. 699 (1980).

LAW AND ANALYSIS

Section 217(a) of the Code provides for the allowance of a deduction for moving expenses paid or incurred during the taxable year in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work. In general, no deduction is allowed under section 217 unless the requirements stated in section 217(c) are satisfied.

Section 217(c)(2) of the Code requires that the taxpayer be either a full-time employee or a self-employed individual for specified time periods following the taxpayer's arrival in the general location of the new principal place of work. For a full-time employee such as *A*, this requirement may be satisfied under section 217(c)(2)(A) if the taxpayer is a full-time employee in the general location of the new principal place of work for at least 39 weeks during the 12-month period immediately following the taxpayer's arrival in that general location.

Under section 217(d)(1) of the Code, the foregoing requirement is inapplicable if the taxpayer is unable to satisfy the requirement by reason of (A) death or disability, or (B) involuntary separation (other than for willful misconduct) from the service of an employer, or a transfer for the benefit of an employer, after obtaining full-time employment in which the taxpayer could reasonably have been expected to satisfy such requirement.

Section 217(d) was added to the Code by the Tax Reform Act of 1969, section 231, 1969-3 C.B. 10, 61-63. Prior to the addition of the section, there was no provision for waiving the 39-week requirement imposed by the predecessor of section 217(c)(2)(A). Section 217(d)(1) was added to eliminate the hardship that arose when an employee "is prevented from satisfying the test by circumstances *beyond his control*, such as his death or an unexpected action of his employer." S. Rep. No. 91-552, 91st Cong., 1st Sess. 108 (1969), 1969-3 C.B. 423, 493 (emphasis added); *see also* H.R. Rep. No., 91-413 (Part 1) 91st Cong., 1st Sess. 75 (1969), 1969-3 C.B. 200,

247. In reliance on this legislative history, the Tax Court has denied moving expense deductions in cases where a taxpayer was not required by the employer to transfer from one location to another. *Muse v. Commissioner*, 76 T.C. 574, 577 (1981), and *Rohwer v. Commissioner*, T.C.M. 1984-60.

In *Rohwer*, the taxpayer transferred from the employer's Bakersfield, California, office to its Los Angeles, California, office in response to the employer's advertisement of the need for additional staff in the Los Angeles office. Because of a hiring freeze at the time of the transfer, the employer could fill vacancies only by transferring employees. The taxpayer had not satisfied the 39-week test in section 217(c)(2)(A) of the Code with respect to the Bakersfield work location. The Tax Court held that while the employee's transfer served a need of the employer, that alone is insufficient under section 217(d)(1)(B) to waive the section 217(c)(2)(A) 39-week requirement. The court concluded that the taxpayer must be *required* by the employer to transfer in order for the transfer to be considered for the employer's benefit for purposes of the section 217(d)(1)(B) waiver. Congress intended to grant relief from the requirement imposed by section 217(c)(2) only in the case of events beyond the taxpayer's control, such as the taxpayer's death, disability, or involuntary termination, or a transfer required by the employer.

In *Muse*, the Tax Court stated that the phrase "transfer for the benefit of an employer" used in section 217(d)(1) " . . .was meant to cover a transfer beyond the control of the employee; that is, a transfer initiated by the employer, not one initiated by the employee." 76 T.C. at 577.

Although *A*'s change of positions was sufficiently in the government's interest for *A*'s moving expenses to be reimbursed, the transfer was initiated by *A* and was not required by *M*. Therefore, the transfer was not for the benefit of *M* within the meaning of section 217(d)(1) of the Code. *A*'s expenses of moving in connection with commencing work on January 2, 1987, for employer *M* in the new location are not deductible because neither the 39-week requirement of section 217(c)(2)(A) nor the waiver provision in section 217(d)(1)(B) has been satisfied.

HOLDING

A is not entitled to a deduction under section 217(a) of the Code for the expenses of moving in connection with commencing work for employer *M*.

Part IX.—Items Not Deductible

Section 263.—Capital Expenditures

26 CFR 1.263(a)-1: Capital expenditures; in general.
(Also Section 612; 1.612-4.)

Intangible drilling and development costs; exploratory holes. Costs incurred to drill expendable holes to determine the location and delineation of offshore hydrocarbon deposits and capable of conducting hydrocarbons to the surface on completion are within the option to expense intangible drilling and development costs (IDC) provided by section 263(c) of the Code regardless of whether there is an intent to produce hydrocarbons.

Rev. Rul. 88-10

ISSUE

Whether costs incurred to drill expendable holes to determine the location and delineation of offshore hydrocarbon deposits are within the option to expense intangible drilling and development costs (IDC) pursuant to section 263(c) of the Internal Revenue Code.

FACTS

The taxpayer, an integrated oil and gas company, was the successful bidder for certain United States oil and gas leases on the outer continental shelf. The taxpayer had previously obtained favorable geological and geophysical information on the lease area. During the tax year, the taxpayer drilled 16 bore holes from mobile drilling rigs in water depths varying from 170 feet to 370 feet and at locations ranging from 25 to 130 miles offshore. The drilling sites were located according to structural interpretations of geological and geophysical data. The bore holes were drilled to ascertain the existence, extent, and configuration of hydrocarbon deposits. The taxpayer sought this information to determine whether to develop the leases and, if it did so, the optimum number and location of wells and platforms that should be used for development. Although the diameters of the bore holes and the casings were similar to those of wells that would be drilled to comparable depths for the production of oil and gas, the bore holes were drilled without the intention of attempting any completions for the production of oil and gas. Some of the bore holes exhibited producing potential, but after testing and logging were plugged and the casings cut off below the sea floor.

LAW AND ANALYSIS

Section 263(a) of the Internal Revenue Code provides that no deduction shall be allowed for capital expenditures. Section 263(c) of the Code provides that, notwithstanding section 263(a), regulations shall be prescribed that grant the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells.

Section 1.612-4 of the Income Tax Regulations provides that intangible drilling and development costs (IDC) incurred by an operator in the development of oil and gas properties may at the operator's option be chargeable to capital or to expense. Expenditures that are included in this option are listed in section 1.612-4(a) as wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas.

In *Standard Oil Co. (Indiana) v. Commissioner*, 68 T.C. 325 (1977), *acq.*, 1983-1 C.B. 1, the Tax Court concluded that the option to capitalize or expense applied to the costs incurred by the taxpayer in drilling offshore expendable holes to determine the location and delineation of offshore hydrocarbon deposits. Although it held that such costs were eligible for the IDC option even under the test urged by the Service, the court went on to add that the dividing line between "exploratory" work that must be capitalized and "development" activities that come within the IDC option should be the point at which the preparation for drilling begins. The court noted that the regulations neither expressly or implicitly limit "wells" to those drilled after a decision has been made to install a permanent drilling and production platform. Accordingly, the court reasoned that the intangible cost of drilling all offshore wells, including those drilled with mobile drilling rigs, should be subject to the IDC option.

In *Gates Rubber Co. v. Commissioner*, 74 T.C. 1456 (1980), *acq.*, 1983-1 C.B. 1, *aff'd per curiam*, 694 F.2d 648 (10th Cir. 1982), the Tax Court confirmed its dicta from the *Standard Oil* case, concluding that the cost of drilling exploratory holes at offshore lease sites comes within the IDC option. The court stated that the Commissioner's attempted distinction between exploratory and development activities would deny the deduction for the precise high risk drillings for which the deduction was intended.

In *Sun Co. v. Commissioner*, 677 F.2d 294 (3rd Cir. 1982), *aff'g* 74 T.C. 1481 (1980), *acq.*, 1983-1 C.B. 1, the Third Circuit affirmed the decision of the Tax Court that the cost of drilling exploratory holes at offshore lease sites comes within the IDC option. The Third Circuit reasoned that since the IDC regulation does not expressly distinguish between exploratory and developmental drilling, the Service's argument, based upon that purported distinction, was misplaced.

The Tax Court, in *Sun Co.* defined the term "well" for purposes of section 263(c) of the Code and section 1.612-4 of the regulations as a shaft drilled in search of hydrocarbons, which is designed and drilled to be capable, upon encountering hydrocarbons and upon appropriate completion of the shaft by the operator, of conducting or aiding in the conduction of hydrocarbons to the surface. This definition of wells excludes shafts such as core drilling which, because of their design or the manner in which they are drilled, are not capable of conducting or aiding in the conduction of hydrocarbons to the surface; they are capable solely of yielding geological information. If an appropriately designed shaft is drilled in search of hydrocarbons, it is a well regardless of whether there is an intent to produce hydrocarbons.

In this case, the bore holes drilled offshore from mobile drilling rigs during the tax year fit the definition of a well. Therefore, the costs incurred by the taxpayer are, at its option, intangible drilling costs chargeable to capital or to expense. These wells are distinguished from offshore stratigraphic test wells described in Rev. Rul. 80-342, 1980-2 C.B. 99, drilled to obtain geological data by the participants who do not have an economic interest in the property.

HOLDING

Costs incurred to drill expendable holes to determine the location and delineation of offshore hydrocarbon deposits are within the option to expense intangible drilling and development costs (IDC) provided by section 263(c) of the Code and section 1.612-4 of the regulations.

Section 263A.—Capitalization and Inclusion in Inventory Costs of Certain Expenses

26 CFR 1.263A-1T: Capitalization and inclusion in inventory of certain costs.

Procedures are provided to allow eligible taxpayers to obtain expeditious consent to discontinue the use of the last-in, first-out (LIFO) inventory method of accounting and to change to an inventory method that is a permitted method. See Rev. Proc. 88-15, page 683.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of January 1988. See Rev. Rul. 88-1, page 307.

Federal short-term, mid-term, and long-term rates are set forth for the month of February 1988. See Rev. Rul. 88-9, page 307.

Federal short-term, mid-term, and long-term rates are set forth for the month of March 1988. See Rev. Rul. 88-15, page 308.

Federal short-term, mid term, and long-term rates are set forth for the month of April 1988. See Rev. Rul. 88-22, page 309.

Federal short-term, mid-term, and long-term rates are set forth for the month of May 1988. See Rev. Rul. 88-28, page 310.

Federal short-term, mid-term, and long-term rates are set forth for the month of June 1988. See Rev. Rul. 88-44, page 312.

Subchapter C.—Corporate Distributions and Adjustments
Part I.—Distributions by Corporations
Subpart A.—Effects on Recipients

Section 302.—Distributions in Redemption of Stock

26 CFR 1.346-1: Partial liquidation.

Several revenue rulings dealing the active trade or business requirement under section 355(b) or the substantially similar requirement under former section 346(b) (now section 302(e)) of the Code have been reconsidered and are being revoked because of the failure of those revenue rulings to state sufficient facts to support their respective conclusions. See Rev. Rul. 88-19, page 114.

Part III.—Corporate Organizations and Reorganizations
Subpart A.—Corporate Organizations

Section 351.—Transfer to Corporation Controlled by Transferor

26 CFR 1.351-1: Transfer to corporation controlled by transferor.

Transfer to corporation controlled by transferor. The transfers of stock of one corporation to a newly created corporation by the transferors followed by the sale of the transferred stock and purchase of other stocks and securities by the transferee corporation do not constitute transfers to an investment company within the meaning of section 351(e) of the Code. The transfers qualify for nonrecognition of gain or loss under section 351(a).

Rev. Rul. 88-32

ISSUE

If several persons transfer the marketable stock of a corporation to a newly organized corporation and the transferee corporation, pursuant to a preexisting plan, subsequently sells the stock and purchases other marketable stocks and securities, do the initial transfers constitute transfers to an "investment company" within the meaning of section 351(e)(1) of the Internal Revenue Code?

FACTS

The stock of *Y* corporation is actively traded on a public stock exchange. Some *Y* shareholders transferred *Y* stock to *X*, a newly organized corporation, in exchange for all of the *X* stock. No assets other than the *Y* stock were transferred to *X*. None of the transferors had acquired any of the *Y* stock transferred to *X* as part of the same plan to organize *X*. However, as part of the same plan, *X* sold significant amounts of the *Y* stock in transactions in which *X* recognized gain or loss. *X* used the proceeds from the sales to purchase other readily marketable stocks and securities. Immediately after the transfer, *Y* will fit the description in section 1.351-1(c)(1)(ii) of the Income Tax Regulations. Except for the question here at issue regarding limitations on transfers to an investment company under section 351(e)(1), the exchange of the *Y* stock for *X* stock met all requirements of section 351 and the regulations thereunder.

LAW AND ANALYSIS

Section 351(a) of the Code provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange the transferors are in control (as defined in section 368(c)) of the corporation.

Section 351(e)(1) of the Code and section 1.351-1(c)(1) of the regulations provide that section 351 will not apply to transfers of property to an investment company ocurring after June 30, 1967. Section 1.351-1(c)(1) further provides that a transfer of property will be considered a transfer to an investment company if (i) the transfer results, directly or indirectly, in diversification of the transferors' interests and (ii) the transferree is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation more than 80 percent of the value of whose assets are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts.

Section 1.351-1(c)(2) of the regulations provides that the determination of whether a corporation is an investment company is ordinarily made by reference to the circumstances in existence immediately after the transfer in question.

Section 1.351-1(c)(5) of the regulations provides that if two or more persons transfer identical assets to a newly organized corporation, the transfer will generally be treated as not resulting in diversification. However, if a transfer is part of a plan to achieve diversification without the recognition of gain, the transfer will be treated as resulting in diversification.

The initial transfer of the *Y* stock to *X* did not result in diversification. The *Y* shareholders transferred identical assets (*Y* stock) to a newly organized corporation (*X*). Under section 1.351-1(c)(5) of the regulations, such a transfer is treated as *not* resulting in diversification unless it is part of a plan to achieve diversification in a series of nonrecognition transactions. In the present situation, although the transferors acquire a more diversified investment than the *Y* stock, by reason of *X*'s subsequent sale of the *Y* stock and *X*'s purchase of other marketable investments, this diversification does not occur in a transaction purporting to qualify for nonrecognition treatment. Thus, despite the economic diversification ultimately enjoyed by this transferors, their transfer of the *Y* stock to *X* does not result in diversification within the meaning of section 1.351-1(c)(1)(i) of the regulations.

HOLDING

The transfers of *Y* stock to *X*, followed by the sale of the *Y* stock by *X* and the purchase of other stocks and securities, do not constitute transfers to an "investment company" within the meaning of section 351(e)(1) of the Code. Therefore, the transfers qualify for nonrecognition of gain or loss to the transferors under section 351(a).

Subpart B.—Effects on Shareholders and Security Holders

Section 354.—Exchanges of Stock and Securities in Certain Reorganizations

26 CFR 1.354-1: Exchanges of stock and securities in certain reorganizations.

When a foreign corporation becomes a domestic corporation pursuant to a state domestication statute, the shareholders will be treated as having exchanged stock or securities in the foreign corporation for stock or securities in the new domestic corporation. See Rev. Rul. 88-25, page 116.

Section 355.—Distribution of Stock and Securities of a Controlled Corporation

26 CFR 1.355-1: Distribution of stock and securities of controlled corporation.
(Also Section 302; 1.346-1.)

Controlled corporation; stock distribution; active business. Several revenue rulings dealing with the active trade or business requirement under section 355(b) or the substantially similar requirement under former section 346(b) (now section 302(e)) of the Code have been reconsidered and are being revoked because of the failure of those revenue rulings to state sufficient facts to support their respective conclusions. Rev. Ruls. 58-164, 57-334, 56-557, 56-555, and 56-554 are revoked.

Rev. Rul. 88-19

The Internal Revenue Service has reconsidered several revenue rulings dealing with the active trade or business requirement under section 355(b) or the substantially similar requirement under former section 346(b) (now section 302(e)) of the Internal Revenue Code.

The active trade or business requirement of these Code provisions connotes substantial managerial and operational activities directly carried on by the corporation. See, e.g., Rev. Rul. 86-126, 1986-2 C.B. 58; Rev. Rul. 86-125, 1986-2 C.B. 57; Rev. Rul. 73-237, 1973-1 C.B. 184; and Rev. Rul. 73-234, 1973-1 C.B. 180. Furthermore, the activities must be sufficient to distinguish the corporation's entrepreneurial endeavors from mere passive investments. See, e.g., Rev. Rul. 79-394, 1979-2 C.B. 141.

The following revenue rulings do not represent the position of the Service because each concluded that the active trade or business test was met but failed to state sufficient facts to support that conclusion: Rev. Rul. 58-164, 1958-1 C.B. 184; Rev. Rul. 57-334, 1957-2 C.B. 240; Rev. Rul. 56-557, 1956-2 C.B. 199, clarified on another point by Rev. Rul. 86-4, 1986-1 C.B. 174; Rev. Rul. 56-555, 1956-2 C.B. 210; and Rev. Rul. 56-554, 1956-2 C.B. 198.

EFFECT ON OTHER REVENUE RULINGS

Rev. Ruls. 58-164, 57-334, 56-557, 56-555, and 56-554 are revoked.

---

26 CFR 1.355-2: Limitations.

Controlled corporation; stock distribution; business purpose. The business purpose requirement of section 1.355-2(c) of the regulations is satisfied when a corporation distributes the stock of its subsidiary in order to eliminate the time, expense and administrative fees involved in meeting state regulatory requirements imposed on the parent corporation because of the subsidiary's business.

Rev. Rul. 88-33

ISSUE

Is the business purpose requirement of section 1.355-2(c) of the Income Tax Regulations satisfied when stock of a controlled corporation is distributed in order to reduce substantially the amount of administrative time and expense necessary for compliance with state regulatory licensing and reporting requirements?

FACTS

P, a large, widely held, publicly traded corporation, has engaged primarily in the design, manufacture, and marketing of computers and associated software. No single *P* shareholder owns as much as 3 percent of the outstanding *P* stock.

At the time the transaction described below was consummated, *S* corporation had been a wholly owned subsidiary of *P* for more than 5 years. *S* had been engaged for over 5 years in the design and manufacture of hardware and software for the electronic gaming industry in state *Q*. No officer or director of *P* was also an officer or director of *S*.

Under the laws of *Q*, every gaming corporation and any corporation related to a gaming corporation must be licensed annually by the *Q* Gaming Commission. Because *S* was a wholly owned subsidiary of *P*, it too was subject to the *Q* licensing procedure. Under the laws of *Q*, *P* would have been subject to the annual licensing procedure even if *P* and *S* were brother-sister corporations. As part of the *Q* annual licensing procedure, both *S* and *P* had to prepare and file detailed annual financial reports. In addition to the annual financial reports, *Q* required that every officer and director of *S* and *P* submit each year to a full personal investigation, including a detailed, lengthy personal questionnaire. The annual licensing fee imposed by *Q* is 25,000*x* dollars for *S*, and an additional 25,000*x* dollars for *P*. The annual preparation of the questionnaires by the officers and directors of *P* involved a significant number of working hours for *P*'s top management. As a result, the amount of time that *P*'s top management could devote to the management of *P*'s business was unnecessarily reduced, which reduction had a significant negative impact on the normal operations of *P*. These questionnaires also required a substantial increase in record keeping and the involvement of *P*'s outside accountants and lawyers at an added annual cost to *P* of 20,000*x* dollars.

In order to eliminate the continuing administrative time and expense directly involving *S*, *P* and its officers and directors in meeting the annual *Q* licensing requirements for *S*, *P* distributed all the *S* stock pro rata to the *P* shareholders. Except for the question of the business purpose, the distribution of *S* stock by *P* met all the requirements of section 355 of the Internal Revenue Code and the applicable regulations.

LAW AND ANALYSIS

Section 355 of the Code provides that under certain circumstances a corporation may distribute stock in a corporation it controls to its shareholders in a transaction in which no gain or loss is recognized to (and no amount is includible in the income of) the shareholders. Section 1.355-2(c) of the regulations provides that a distribution by a corporation of stock of a controlled corporation to its shareholders with respect to its own stock will not qualify under section 355 if carried out for purposes not germane to the business of the corporations. This provision is intended to limit the application of section 355 to those readjustments of corporate structure that are required by business exigencies.

Several revenue rulings have found a valid business purpose for a distribution under section 355 of the Code where the transaction resulted in a substantial reduction in the costs of doing business or a substantial reduction in impediments to the business of either the distributing or controlled corporation. Rev. Rul. 76-187, 1976-1 C.B. 97, concerned a distribution of the stock of a subsidiary corporation to the sole corporate shareholder in order to reduce substantially the amount of state and local capital taxes paid by the corporations. The ruling holds that the distribution was undertaken for a valid business purpose. In Rev. Rul 77-22, 1977-1 C.B. 91, a distribution of the stock of a subsidiary in order to increase the amount of commercial credit that would be available constituted a valid business purpose under section 355.

In the present situation, the distribution was undertaken for reasons similar to those in the cited revenue rulings—to eliminate significant limitations on profitability. The distribution relieved *P* of a substantial annual administrative burden imposed upon it and its management by *Q* as a result of *P's* stock ownership of *S*; and it removed *P's* computer business from the gaming licensing review of *Q*. An important factor present here is the annually recurring negative effect on business that was relieved by the distribution. Accordingly, the distribution by *P* of the *S* stock was for a purpose germane to the business of *P* within the meaning of section 1.355-2(c) of the regulations.

HOLDING

The business purpose requirement of section 1.355-2(c) of the regulations is satisfied by *P*'s distribution of *S* stock to remove *P*'s nongaming business from the licensing review process and to free *P* from the substantial continuing administrative expense and time required of *P* by *Q* for the annual licensing of *S*.

---

26 CFR 1.355-2: Limitations.

Controlled corporation; stock distribution; business purpose. The business purpose requirement under section 355 of the Code is met if a corporation distributes all of the stock of its subsidiary corporation in order to enable the subsidiary to hire a key employee who also wishes to acquire shares of stock of the subsidiary.

Rev. Rul. 88-34

ISSUE

Is the business purpose requirement of section 355 of the Internal Revenue Code and section 1.355-2(c) of the Income Tax Regulations met where a distribution of the stock of a controlled corporation is made to enable that corporation to hire a new president?

FACTS

X, a large widely held and publicly traded corporation, owned all the stock of *Y* corporation for more than five years. *X* and *Y* were each engaged in the active conduct of a separate and distinct trade or business for over five years. No shareholder of *X* owns as much as 5 percent of the outstanding stock of *X*.

The president of *Y* has recently retired and *Y* has conducted an extensive search for a new president. *Y* has interviewed *A*, an individual with substantial prior experience and an outstanding reputation as the president of a public corporation engaged in the same line of business as *Y*. Because of *A's* prior experience and success in managing a similar corporation, *A* is the person *Y* wishes to hire as its new president. *A* is interested in becoming the president of *Y* but will not accept the position unless permitted to acquire a significant equity interest in *Y*. *A* has further advised *Y* that *A* is not interested in acquiring *X* stock or in acquiring an equity interest in *Y* as a subsidiary of *X*.

In order to permit *Y* to obtain the services of *A*, *X* has distributed all of the stock of *Y* pro rata to the shareholders. Thereafter, *A* will be employed by *Y* at an annual salary of $250x and, within one year, will purchase newly issued shares of stock from *Y* having a fair market value of $775x.

Except for the issue of the business purpose for the distribution, the proposed distribution by *X* of the *Y* stock meets all the requirements of section 355 of the Code and the pertinent regulations.

LAW AND ANALYSIS

Section 355 of the Code provides that under certain circumstances a corporation may distribute stock or securities in a corporation it controls to its shareholders or security holders in a transaction that is not taxable to those shareholders or security holders. Section 1.355-2(c) of the regulations states that a distribution by a corporation of stock or securities of a controlled corporation will not qualify under section 355 when carried out for purposes not germane to the business of the corporations. This provision is intended to limit the application of section 355 to those readjustments of a corporate structure that are required by business exigencies.

Situation 2 of Rev. Rul. 69-460, 1969-2 C.B. 51, concerns a distribution of the stock of a subsidiary corporation so that key employees of the parent corporation could afford to buy stock in that corporation. That ruling holds that the distribution was undertaken for a valid business purpose. Rev. Rul. 85-127, 1985-2 C.B. 119, holds that the business purpose requirement was also met where a corporation transfers one of its businesses to a new corporation and distributes the stock of the new corporation to its shareholders in order to retain the services of a key employee and permit that employee to obtain a majority of the stock of the new corporation.

In the present situation, the distribution enables the subsidiary corporation to hire the key employee it believes is necessary to the continued success of the business. This is consistent with both Rev. Rul. 69-460 (Situation 2) and Rev. Rul. 85-127.

HOLDING

The pro rata distribution of the stock of *Y* by *X* to the *X* shareholders to enable *Y* to hire *A* as its new president is for a valid business purpose within the meaning of section 1.355-2(c) of the regulations. The distribution qualifies under section 355 of the Code because all other requirements of section 355 and the regulations thereunder have been met.

Subpart C.—Effects on Corporations

Section 361.--Nonrecognition of Gain or Loss to Transferor Corporations; Other Treatment of Transferor Corporation: Etc.

26 CFR 1.361-1: Nonrecognition of gain or loss to corporations.

When a foreign corporation becomes a domestic corporation pursuant to a state domestication statute, section 361 is applicable to the transaction. See Rev. Rul. 88-25, below.

Subpart D.—Special Rules; Definitions

Section 367.—Foreign Corporations

26 CFR 7.367(b)-7: Exchange of stock described in section 354.

When a foreign corporation becomes a domestic corporation pursuant to a state domestication statute, section 367(b) will apply to the transaction. See Rev. Rul. 88-25, below.

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368-1: Purpose and scope of exception of reorganization exchanges.

Pursuant to a modification of the no-ruling area under Rev. Proc. 88-3, the Service will issue rulings as to whether a transaction constitutes a corporate recapitalization under section 368(a)(1)(E) of the Code except in certain specified situations. See Rev. Proc. 88-25, page 803.

---

26 CFR 1.368-2: Definition of terms.
(Also Sections 354, 361, 367, 897; 1.354-1, 1.361-1, 7.367(b) 7.)

Reorganizations; conversion of foreign corporation to domestic. The conversion of a foreign corporation to a domestic corporation pursuant to a state domestication statute will be treated as a reorganization qualifying under section 368(a)(1)(F) of the Code.

Rev. Rul. 88-25

ISSUE

What is the federal income tax treatment of the conversion of a foreign corporation to a domestic corporation under a state domestication statute?

FACTS

F was incorporated in Country *Y*. For valid business reasons, the shareholders of *F* decided that it would be advantageous for *F* to become a State *A* corporation. Under State *A* corporate law, a foreign corporation may become a State *A* corporation by filing a certificate of domestication and a certificate of incorporation with the appropriate official. Pursuant to a plan of reorganization, *F* filed a certificate of domestication and a certificate of incorporation in State *A*.

Upon filing the certificate of domestication and certificate of incorporation, *F* was considered by State *A* to be incorporated in State *A* and became subject to State *A* law, whether or not *F* continued to be considered a Country *Y* corporation for Country *Y* purposes. Thus, *F* was not required to incorporate anew in State *A*, but merely "converted" itself into a State *A* corporation by filing the appropriate documents. For State *A* law purposes, the existence of *F* was deemed to have commenced on the date *F* commenced its existence in Country *Y*.

Following the domestication, *F* possessed the same assets and liabilities as before the domestication and continued its previous business without interruption. There was no change in the shareholders of *F* or in the shareholders' proprietary interests.

LAW AND ANALYSIS

For federal income tax purposes, the conversion of *F* from a Country *Y* to a State *A* corporation under the State *A* domestication statute is treated as: (1) a transfer by a foreign corporation (*F*) of all of its assets and liabilities to a new domestic corporation (*F-D*) in exchange for *F-D* stock; and (2) a liquidating distribution by *F* to its shareholders of the *F-D* stock received in exchange for *F*'s assets and liabilities. There was no change in the shareholders of *F* or in the shareholders' proprietary interests. Furthermore, *F-D* possessed the same assets and liabilities and continued the same business activities after the conversion as *F* did before the conversion. Because there was no alteration in shareholder continuity, asset continuity, or business enterprise, the effect of the conversion was a mere change in the place of organization of *F*. Therefore, the conversion qualified as a reorganization under section 368(a)(1)(F) of the Internal Revenue Code, which provides that the term "reorganization" includes a mere change in identity, form, or place of organization of one corporation, however effected. See Rev. Rul. 87-27, 1987-1 C.B. 134, concluding that the reincorporation in a foreign country of a dual resident U.S. corporation was a reorganization under section 368(a)(1)(F). *F*, the transferor corporation, and *F-D*, the transferee corporation, are considered "part[ies] to a reorganization" under section 368(b).

Generally, section 361 and section 354 of the Code provide the transferor corporation and the shareholders of the transferor corporation, respectively, with nonrecognition treatment in a reorganization under section 368. However, in certain circumstances, the nonrecognition treatment normally accorded to the transferor corporation and its shareholders in an international reorganization is overridden by the operation of section 367 and the corresponding regulations, or the rules of sections 897(d) and (e). If, for example, a corporate shareholder of *F* is a "United States shareholder" under section 7.367(b)-2(b) of the Temporary Income Tax Regulations, then the shareholder is denied section 354 nonrecognition treatment unless it agrees to include the "all earnings and profits amount" in income as a dividend. *See* section 7.367(b)-7(c)(2) of the Temporary Regulations.

In addition, section 897(e)(1) of the Code denies section 361 nonrecognition treatment to *F* with respect to the transfer by *F* to *F-D* of any "United States real property interest[s]" if *F-D* is not a "United States real property holding corporation" immediately after the exchange. Furthermore, subject to section 897(d)(2) or regulations to be promulgated, section 897(d)(1) denies section 361 nonrecognition treatment to *F* on the distribution to its shareholders (whether U.S. or foreign) of the *F-D* stock constitutes a U.S. real property interest at the time of the distribution. See Rev. Rul. 87-66, 1987-2 C.B. 168, for a more complete discussion of the treatment of reorganizations involving the transfer of U.S. real property interests by a foreign corporation to a U.S. corporation.

HOLDING

For federal income tax purposes, the conversion of *F* from a Country *Y* corporation to a State *A* corporation under the State *A* domestication statute is treated as a transfer by *F* of its assets and liabilities to a new corporation (*F-D*) and a distribution by *F* to its shareholders of the *F-D* stock received in exchange. The transaction qualifies as a reorganization under section 368(a)(1)(F) of the Code.

---

26 CFR 1.368-2: Definition of terms.

Reorganization; "substantially all" requirement. If a transferor corporation sells 50 percent of its historic assets to unrelated parties for cash and immediately afterwards transfers to an acquiring corporation all of its assets (including cash from the sale), the transfer meets the "substantially all" requirement of section 368(a)(1)(C) of the Code.

Rev. Rul. 88-48

ISSUE

If a transferor corporation sold 50 percent of its historic assets to unrelated parties for cash and immediately afterwards transferred to an acquiring corporation all of its assets (including the cash from the sale), did the subsequent transfer meet the "substantially all" requirement of section 368(a)(1)(C) of the Internal Revenue Code?

FACTS

X and *Y* were unrelated corporations that for many years were engaged in the hardware business. *X* operated two significant lines of business, a retail hardware business and a wholesale plumbing supply business. *Y* desired to acquire and continue to operate *X*'s hardware business but did not desire to acquire the other business. Accordingly, pursuant to an overall plan, the following steps were taken. First, in a taxable transaction, *X* sold its entire interest in the plumbing supply business (constituting 50 percent of its total historic business assets) to purchasers unrelated to either *X* or *Y* or their shareholders. Second, *X* transferred all of its assets, including the cash proceeds from the sale, to *Y* solely for *Y* voting stock and the assumption of *X*'s liabilities. Finally, in pursuance of the plan of reorganization, *X* distributed the *Y* stock (the sole asset *X* then held) to the *X* shareholders in complete liquidation.

Except for the issue relating to the "substantially all" requirement, the transfer of assets from *X* to *Y* constituted a corporate reorganization within the meaning of section 368(a)(1)(C) of the Code.

LAW AND ANALYSIS

Section 368(a)(1)(C) of the Code defines a corporate reorganization to include the acquisition by one corporation, in exchange solely for all or part of its voting stock, of substantially all the properties of another corporation.

Section 368(a)(1)(C) of the Code is intended to accommodate transactions that are, in effect, mergers, but which fail to meet the statutory requirements that would bring them within section 368(a)(1)(A). *See* S. Rep. No. 558, 73d Cong., 2d Sess. 16, 17 (1939), 1939-1 C.B. (Pt. 2) 586, 598.

Congress intended that transactions that are divisive in nature not qualify under section 368(a)(1)(C) of the Code, but, instead, be subject to the tests under section 368(a)(1)(D). *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 274 (1954). The enactment of section 368(a)(2)(G) indicates the continuing interest in furthering this underlying objective of preventing divisive "C" reorganizations.

Rev. Rul. 57-518, 1957-2 C.B. 253, concerns whether, in a "C" reorganization, assets may be retained to pay liabilities. The ruling states that what constitutes "substantially all" for purposes of section 368(a)(1)(C) of the Code depends on the facts and circumstances in each case. Rev. Rul. 57-518 exemplifies the Service's longstanding position that where some assets are transferred to the acquiring corporation and other assets retained, then the transaction may be divisive and so fail to meet the "substantially all" requirement of section 368(a)(1)(C). *See also* Rev. Rul. 78-47, 1978-1 C.B. 113.

In the present situation, 50 percent of the *X* assets acquired by *Y* consisted of cash from the sale of one of *X*'s significant historic businesses. Although *Y* acquired substantially all the assets *X* held at the time of transfer, the prior sale prevented *Y* from acquiring substantially all of *X*'s historic business assets. The transaction here at issue, however, was not divisive. The sale proceeds were not retained by the transferor corporation or its shareholders, but were transferred to the acquiring corporation. Moreover, the prior sale of the historic business assets was to unrelated purchasers, and the *X* shareholders retained no interest, direct or indirect, in these assets. Under these circumstances, the "substantially all" requirement of section 368(a)(1)(C) was met because all of the assets of *X* were transferred to *Y*.

HOLDING

The transfer of all of its assets by *X* to *Y* met the "substantially all" requirement of section 368(a)(1)(C) of the Code, even though immediately prior to the transfer *X* sold 50 percent of its historic business assets to unrelated parties for cash and transferred that cash to *Y* instead of the historic assets.

Part V.—Carryovers

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted federal long-term rate is set forth for the month of January 1988. See Rev. Rul. 88-1, page 307.

The adjusted federal long-term rate is set forth for the month of February 1988. See Rev. Rul. 88-9, page 307.

The adjusted federal long-term rate is set forth for the month of March 1988. See Rev. Rul. 88-15, page 308.

The adjusted federal long-term rate is set forth for the month of May 1988. See Rev. Rul. 88-28, page 310.

The adjusted federal long-term rate is set forth for the month of June 1988. See Rev. Rul. 88-44, page 312.

Section 383.—Special Limitations on Unused Business Credits, Research Credits, Foreign Taxes, and Capital Losses

The adjusted federal long-term rate is set forth for the month of January 1988. See Rev. Rul. 88-1, page 307.

Subchapter D.—Deferred Compensation, etc.
Part I.—Pension, Profit-Sharing, Stock Bonus Plans, etc.
Subpart A.—General Rule

Section 408.—Individual Retirement Accounts

26 CFR 1.408-7: Reports on distributions from individual retirement plans.

Printing of substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 88-28, page 804.

Subpart B.—Special Rules

Section 410.—Minimum Participation Standards

26 CFR 1.410(a)-3T: Minimum age and service conditions.

T.D. 8170

TITLE 26.—INTERNAL REVENUE—CHAPTER I, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953
Minimum Vesting Standards

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations regarding the minimum vesting standards for qualified employee plans. These temporary regulations conform to changes in the law made by the Tax Reform Act of 1986. The regulations provide the public with guidance needed to comply with the minimum vesting standards and affect all employers maintaining qualified plans. The text of the temporary regulations *** [page 881, this Bulletin] also serves as the text of the proposed regulations.

DATES: These temporary regulations are generally effective for plan years beginning after December 31, 1988.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains temporary regulations regarding the minimum vesting standards for qualified employee plans under sections 410 and 411 of the Internal Revenue Code of 1986. These temporary regulations conform to the changes made by sections 1113(a), (c), and (d) of the

Tax Reform Act of 1986 (Pub. L. 99-514) [1986-3 C.B. (Vol.1) 1, 363] and are required by section 1141 of that Act. These temporary regulations do not reflect amendments to the Internal Revenue Code made by the Retirement Equity Act of 1984 (Pub. L. 98-397, 98 Stat. 1436, *et seq.*) [1984-2 C.B. 433], the technical corrections to the Retirement Equity Act of 1984 (section 1898 of the Tax Reform Act of 1986) [1986-3 C.B. (Vol.1) 1, 858], the Omnibus Budget Reconciliation Act of 1986 (Pub. L. 99-509), or section 1113(b) of the Tax Reform Act 1986 [1986-3 C.B. (Vol.1) 1, 364] (repealing section 411(d)(4), pertaining to class year vesting), and no inferences should be drawn by reason of the fact that an issue relating to these amendments is not addressed in these temporary regulations. There is a need for immediate guidance so that employers maintaining qualified plans can comply by making the necessary plan amendments to conform the plans to the new minimum vesting standards. These regulations will remain in effect until superseded by final regulations on this subject.

PRIOR LAW

An employee plan does not qualify under section 401(a) unless it satisfies the minimum participation standards of section 410(a) and the minimum vesting standards of section 411(a). In general, section 410(a) provides that a plan will not qualify if it requires, as a condition of participation in the plan, that an employee complete a period of service with the employer beyond the later of the date on which the employee attains age 21 or the date on which the employee completes a year of service. An exception, however, is provided for plans providing that after not more than 3 years of service each participant has a right to 100 percent of his or her accrued benefit under the plan. In such a plan, participation may be conditioned on not more than 3 years of service. Section 411(a) provides that a plan will not qualify unless an employee's right to his or her accrued benefits derived from employer contributions becomes nonforfeitable (1) upon the attainment of normal retirement age; and (2) at least as rapidly as under one of three alternative minimum vesting schedules. Section 411(a)(2) sets out the schedules as follows: (A) 10-year cliff vesting (100 percent vesting after 10-years of service); (B) 5- to 15-year graded vesting (25 percent vesting after 5 years of service, increasing gradually to 100 percent after 15 years of service); and (C) Rule of 45 (taking both age and service into account so that an employee who has completed at least 5 years of service, and the sum of whose age and years of service equals or exceeds 45, vests according to a table, but, in any event, in 50 percent after 10 years of service and an additional 10 percent for each additional year of service).

Section 411(a)(10)(B) provides that a plan amendment changing the plan's vesting schedule must permit all employees with at least 5 years of service to elect to remain under the vesting schedule in effect prior to the amendment.

EXPLANATION OF PROVISIONS

Sections 1113(a), (c), and (d) of the Tax Reform Act of 1986 amended sections 410(a) and 411(a). Section 410(a) was amended to provide that a plan may require no more than 2 years of service with the employer as a condition of participation in the plan if the plan provides for 100 percent vesting after no more than 2 years. Section 411(a) was amended to provide that an employee's right to all accrued benefits derived from employer contributions must become nonforfeitable at least as rapidly as under one of two alternative schedules, changing 10-year cliff vesting to 5-year cliff vesting and changing the 5- to 15-year graded schedule to a 3- to 7-year graded schedule. Ten-year cliff vesting is still allowed in the case of certain employees covered pursuant to a collective bargaining agreement and participating in a multiemployer plan. Employees who are not covered by the collective bargaining agreement are not eligible for the 10-year cliff vesting schedule, even if such employees are in the multiemployer plan pursuant to a participation agreement that relates to the collective bargaining agreement. Further, section 411(a)(10)(B) was amended to provide that plan amendment changing the plan's vesting schedule must permit employees with 3, rather than 5, years of service to elect to remain under the prior vesting schedule. These changes apply to all accrued benefits derived from employer contributions whether accrued before or after the effective date of the changes. This Treasury decision provides temporary regulations in conformity with these changes.

NONAPPLICABILITY OF EXECUTIVE ORDER 12291

The Commissioner of Internal Revenue has determined that this rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

REGULATORY FLEXIBILITY ACT

A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, these temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

INCOME TAX REGULATIONS

(26 CFR Part 1)

Paragraph 1. The authority citation for Part 1 continues to read in part:

Authority: 26 U.S.C. 7805 ***

Par. 2. New §1.410(a)-3T is added immediately after §1.410(a)-3 to read as follows:

§1.410(a)-3T. Minimum age and service conditions.

(a) [Reserved.]

(b) *Special rule for plan with 2-year 100 percent vesting.* A plan which provides that after not more than 2 years of service each participant's right to his or her accrued benefit under the plan is completely nonforfeitable (within the meaning of section 411 and the regulations thereunder) at the time such benefit accrues satisfies the requirements of paragraph (a) of this section if the period of service required by the plan as a condition of participation does not extend beyond the later of—

(1) [Reserved.]

(2) *Two years of services.* The date on which the employee completes 2 years of service. For employees not

described in §1.411(a)-3T(e)(1), which describes employees with one hour of service in any plan year beginning after December 31, 1988, or later in the case of certain collectively bargained plans, the preceding sentence shall be applied by substituting "3 years of service" for "2 years of service".

Par. 3. New §1.410(a)-8T is added immediately after §1.410(a)-7T to read as follows:

§1.410(a)-8T. Year of service; break in service.

(a) [Reserved.]

(b) [Reserved.]

(c) *Breaks in service*—

(1) [Reserved.]

(2) *Employees under 2-year 100 percent vesting schedule*—(i) *General rule*. In the case of an employee who incurs a 1-year break in service under a plan which provides that after not more than 2 years of service each participant's right to his accrued benefit under the plan is completely nonforfeitable (within the meaning of section 411 and the regulations thereunder) at the time such benefit accrues, the employee's service before the break in service is not required to be taken into account after the break in service in determining the employee's years of service under section 410(a)(1) and §1.410(a)-3 if such employee has not satisfied such service requirement.

(ii) *Example*. The rules of this subparagraph are illustrated by the following example:

Example. A qualified plan computing service by the actual counting of hours provides full and immediate vesting. The plan can not require as a condition of participation that an employee complete 2 consecutive years of service with the employer because the requirement as to consecutive years is not permitted under section 410(a)(5). However, such a plan can require 2 years without a break in service, i.e., 2 years with no intervening years in which the employee fails to complete more than 500 hours of service. Under a plan containing such a participation requirement, the following example illustrates when employees would become eligible to participate.

	Hours of service completed		
Year	Employee A	Employee B	Employee C
1	1,000	1,000	1,000
2	1,000	700	500
3	1,000	1,000	1,000
4	1,000	1,000	700
5	1,000	1,000	1,000

Note.—Employee A will have satisfied the plan's service requirement at the end of year 2, Employee B at the end of year 3, and Employee C at the end of year 5.

(3) *One-year break in service*—

(i) [Reserved.]

(ii) *Examples*. The rules provided by this subparagraph are illustrated by the following examples:

Example (1). Employee A completes a year of service under a plan computing service by the actual counting of hours for the 12-month period ending December 31, 1989, and incurs a 1-year break in service for the 12-month period ending December 31, 1990. The plan does not contain the provisions permitted by section 410(a)(5)(B) (relating to 2-year 100 percent vesting) and section 410(a)(5)(D) (relating to nonvested participants). Thereafter, he does not complete a year of service. As of January 1, 1991, in computing his period of service under the plan his service prior to December 31, 1990, is not required to be taken into account for purposes of section 410(a)(1) and §1.410(a)-3.

Example (2). [Reserved.]

Par. 4. New §1.410(a)-9T is added immediately after §1.410(a)-8T to read as follows:

§1.410(a)-9T. Elapsed time.

(a) [Reserved.]

(b) [Reserved.]

(c) *Eligibility to participate*—

(1) [Reserved.]

(2) *Determination of one-year period of service*.

(i) [Reserved.]

(ii) For purposes of section 410(a)(1)(B)(i), a "2-year period of service" shall be deemed to be "2 years of service."

(d) *Vesting*—(1) *General rule*.

(i) [Reserved.]

(ii) [Reserved.]

(iii) [Reserved.]

(iv) For purposes of determining an employee's nonforfeitable percentage of accrued benefits derived from employer contributions, a plan, after calculating an employee's period of service in the manner prescribed in this paragraph, may disregard any remaining less than whole year, 12-month or 365-day period of service. Thus, for example, if a plan provides for the statutory three to seven year graded vesting, an employee with a period (or periods) of service which yields 3 whole year periods of service and an additional 321-day period of service is twenty percent vested in his or her employer-derived accrued benefits (based solely on the 3 whole year periods of service).

(2) [Reserved.]

Par. 5. New §1.411(a)-3T is added immediately after §1.411(a)-3 to read as follows:

§1.411(a)-3T. Vesting in employer-derived benefits.

(a) *In general*.

(1) [Reserved.]

(2) *Composite arrangements*. A plan will not be considered to satisfy the requirements of paragraph (b), (c), or (d) of this section unless it satisfies all requirements of a particular one of such paragraphs with respect to all of an employee's years of service. A plan which, for example, satisfies the requirements of paragraph (b) (but not (c) or (d)) for an employee's first 4 years of service and satisfies the requirements of paragraph (c) (but not (b)) for all of his remaining years of service does not satisfy the requirements of this section. A plan is not precluded from satisfying the requirements of one such paragraph with respect to one group of employees and another such paragraph with respect to another group provided that the groups are not so structured as to evade the requirements of this paragraph.

(3) [Reserved.]

(b) *5-year vesting*. A plan satisfies the requirements of section 411(a)(2)(A) and this paragraph if an employee who has completed 5 years of service has a nonforfeitable right to 100 percent of his or her accrued benefits derived from employer contributions.

(c) *3- to 7-year vesting*. A plan satisfies the requirements of section 411(a)(2)(B) and this paragraph if an employee who has completed at least 3 years of service has a nonforfeitable right to a percentage of his accrued benefit derived from employer contributions, which percentage is not less than the nonforfeitable percentage determined under the following table:

Completed years of service	Nonforfeitable percentage
3	20
4	40
5	60
6	80
7 or more	100

(d) *Multiemployer plans.* A plan satisfies the requirements of section 411(a)(2)(C) and this paragraph if—

(1) The plan is a multiemployer plan (within the meaning of section 414(f)), and

(2) Under the plan—

(i) An employee who is covered pursuant to a collective bargaining agreement described in section 414(f)(1)(B) has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions not later than upon completion of 10 years of service, and

(ii) The requirements of paragraph (b) or (c) of this section are met with respect to employees who are not covered pursuant to a collective bargaining agreement described in section 414(f)(1)(B).

(iii) For purposes of this provision, an employee is not covered pursuant to a collective bargaining agreement unless the employee is represented by a bona fide employee representative that is a party to the collective bargaining agreement pursuant to which the multiemployer plan is maintained. Thus, for example, an employee of either the multiemployer plan or the employee representative is not covered pursuant to the collective bargaining agreement under which the plan is maintained even if the employee is covered pursuant to an agreement entered into by the multiemployer plan or employee representative on behalf of the employee and even if all such employees covered under the plan constitute only a de minimis percentage of the total employees covered under the plan.

(e) *Effective date.* (1) The provisions of this section apply to all employees who have one hour of service in any plan year beginning after—

(i) December 31, 1988, or

(ii) In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, for employees covered by any such agreement, the earlier of—

(A) the later of—

(*1*) January 1, 1989, or

(*2*) the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986), or

(B) January 1, 1991.

(2) For employees not described in paragraph (e)(1), above, the regulations in effect prior to January 1, 1989, shall be applied to determine the requirements of this section.

(f) *Examples.* The rules provided by this section are illustrated by the following examples:

Example (1). Plan B provides that each employee's rights to his employer-derived accrued benefit are nonforfeitable as follows:

Completed years of service	Nonforfeitable percentage
1	0
2	10
3	25
4	45
5	65
6	75
7	100

Plan B does not satisfy the requirements of paragraph (c) of this section (relating to 3- to 7-year vesting) because the nonforfeitable percentage provided by the plan after completion of 6 years of service (75 percent) is less than the percentage required by paragraph (c) of this section at that time (80 percent). The fact that the nonforfeitable percentage provided by the plan for years prior to the 6th year of service is greater than the percentage required under paragraph (c) of this section is immaterial. The plan fails to satisfy the requirements of paragraph (c) of this section even if it is demonstrated that the value of the vesting provided by the plan to the employees is at least equal to the value of the vesting rate required by this paragraph.

Example (2). Plan C provides for plan participation after the completion of 1 year of service. The plan provides that each employee's rights to his employer-derived accrued benefits are 100 percent nonforfeitable after 5 years of plan participation rather than service. The plan does not satisfy the requirements of paragraph (b) of this section because, under the plan, an employee obtains a 100 percent nonforfeitable right to his or her employer-derived accrued benefit only after completion of more than 5 years of service.

Example (3). Plan D provides that each employee's rights to his employer-derived accrued benefits are nonforfeitable in accordance with the following schedule:

Completed years of service	Nonforfeitable percentage
0–4	0
5	60
6	80
7	100

The plan does not satisfy the requirements of paragraph (b) of this section after the 4th year of service. It does not satisfy the requirements of paragraph (c) of this section for years prior to the 5th year of service. The plan does not satisfy the requirements of this section because it does not satisfy the requirements of a particular one of the two paragraphs for each of an employee's years of service.

Example (4). Plan G provides that each employee's rights to his employer-derived accrued benefit are 100 percent nonforfeitable upon completion of 3 years of service. The plan satisfies the requirements of paragraphs (b) and (c) of this section and, because it satisfies the requirements of at least one of such paragraphs for all of an employee's years of service, it satisfies the requirements of this section.

Par. 6. New §1.411(a)–4T is added immediately after §1.411(a)–4 to read as follows:

§1.411(a)–4T. Forfeitures, suspensions, etc.

(a) *Nonforfeitability.* Certain rights in an accrued benefit must be nonforfeitable to satisfy the requirements of section 411(a). This section defines the term "nonforfeitable" for purposes of these requirements. For purposes of section 411 and the regulations thereunder, a right to an accrued benefit is considered to be nonforfeitable at a particular time if, at that time and thereafter, it is an unconditional right. Except as provided by paragraph (b) of this section, a right which, at a particular time, is conditioned under the plan upon a subsequent event, subsequent performance, or subsequent forbearance which will cause the loss of such right is a forfeitable right at that time. Certain adjustments to plan benefits, such as adjustments in excess of reasonable actuarial reductions, can result in rights being forfeitable. Rights which are conditioned upon a sufficiency of plan assets in the event of a termination or partial termination are considered to be forfeitable because of such condition. However, a plan does not violate the nonforfeitability requirements merely because in the event of a termination an employee does not have any recourse toward satisfaction of his nonforfeitable benefits from other than the plan assets, the Pension Benefit Guaranty Corporation, or a trust established and maintained pursuant to sections 4041(c)(3)(B)(ii) or (iii) and section 4049 of ERISA with respect to the plan. Furthermore, nonforfeitable rights are not considered to be forfeitable by reason of the fact that they may be reduced as allowed under sections 401(a)(5) and 401(l). To the extent that rights are not required to be nonforfeitable to satisfy the minimum vesting standards, or the nondiscrimination requirements of section 401(a)(4), they may be forfeited without regard to the limitations on forfeitability required by this section. The right of an employee to repurchase his accrued benefit, for example under section 411(a)(3)(D), is an example of a right which is required to satisfy such standards. Accordingly, such a right is subject to the limitations on forfeitability. Rights which are required to be prospectively nonforfeitable under the vesting standards are nonforfeitable and may not be forfeited until it is determined that such rights are, in fact, in excess of the vesting standards. Thus, employees have a right to vest in the accrued benefits if they continue in employment of employers maintaining the plan unless a forfeitable event recognized by section 411 occurs. For example, if a plan covered employees in Division A of Corporation X under a plan utilizing a 5-year 100 percent vesting schedule, the plan could not forfeit employees' rights on account of their moving to service in Division B of Corporation X prior to completion of 5 years of service even though employees are not vested at that time.

(b) [Reserved.]

(c) *Examples*. The rules of this section are illustrated by the following examples:

Example (1). Corporation A's plan provides that an employee is fully vested in his employer-derived accrued benefit after completion of 3 years of service. The plan also provides that if the employee works for a competitor he forfeits his right in the plan. Such provision could result in the forfeiture of an employee's rights which are required to be nonforfeitable under section 411 and therefore the plan would not satisfy the requirements of section 411. If the plan limited the forfeiture to employees who completed less than 5 years of service, the plan would not fail to satisfy the requirements of section 411 because the forfeitures under this provision are limited to rights which are in excess of the minimum required to be nonforfeitable under section 411(a)(2)(A).

Example (2). [Reserved.]

Par. 7. New §1.411(a)-8T is added immediately after §1.411(a)-8 to read as follows:

§1.411(a)-8T. Changes in vesting schedule.

(a) [Reserved.]

(b) *Election of former schedule—*(1) *In general*. Under section 411(a)(10)(B), for plan years for which section 411 applies, if the vesting schedule of a plan is amended, the plan will not be treated as meeting the minimum vesting standards of section 411(a)(2) unless the plan as amended provides that each participant whose nonforfeitable percentage of his accrued benefit derived from employer contributions is determined under such schedule, and who has completed at least 3 years of service with the employer, may elect, during the election period, to have the nonforfeitable percentage of his accrued benefit derived from employer contributions determined without regard to such amendment. Notwithstanding the preceding sentence, no election need be provided for any participant whose nonforfeitable percentage under the plan, as amended, at any time cannot be less than such percentage determined without regard to such amendment. For employees not described in §1.411(a)-3T(e)(1), this section shall be applied by substituting "5 years of service" for "3 years of service" where such language appears.

(2) *Election period*. For purposes of subparagraph (1) of this paragraph, the election period under the plan must begin no later than the date the plan amendment is adopted and end no earlier than the latest of the following dates:

(i) The date which is 60 days after the day the plan amendment is adopted,

(ii) The date which is 60 days after the day the plan amendment becomes effective, or

(iii) The date which is 60 days after the day the participant is issued written notice of the plan amendment by the employer or plan administrator.

(3) *Service requirement*. For purposes of subparagraph (1) of this paragraph, a participant shall be considered to have completed 3 years of service if such participant has completed 3 years of service, whether or not consecutive, without regard to the exceptions of section 411(a)(4) prior to the expiration of the election period described in subparagraph (2) of this paragraph. For the meaning of the term "year of service", see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

There is a need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it would be impractical to issue it first under the notice and comment procedure provided in 5 U.S.C. 553(b) or subject to the effective date limitation of 5 U.S.C. 553(d).

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved November 23, 1987.

O. Donaldson Chapoton,
Assistant Secretary of
The Treasury.

(Filed by the Office of the Federal Register on January 5, 1988, 8:45 a.m., and published in the issue of the Federal Register for January 6, 1988, 53 F.R. 261)

Section 412.—Minimum Funding Standards

The procedure described in Rev. Proc. 83-41, 1983-1 C.B. 775, to obtain a waiver from the minimum funding standards is modified to reflect changes made by the Single Employer Pension Plan Amendments Act of 1986. See Rev. Proc. 88-5, page 587.

Section 414.—Definitions and Special Rules

26 CFR 1.414(b)-1: Controlled group of corporations.

T.D. 8179

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; SUBCHAPTER H—INTERNAL REVENUE PRACTICE; PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Organizations Under Common Control; 80% Control Test for a Brother-Sister Controlled Group

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations and withdrawal of temporary regulations.

SUMMARY: This document provides final regulations relating to organizations under common control for purposes of certain rules relating to pension, profit-sharing, and stock bonus plans. The applicable tax law was enacted as part of the Employee Retirement Income Security Act of 1974 (ERISA) and amended by the Revenue Act of 1978 (1978 Act) and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). This document also contains final amendments to the income tax regulations relating to the definition of a brother-sister group of corporations under common control. These amendments conform the regulations to the decision in *United States v. Vogel Fertilizer* by the Supreme Court which held that a person's stock ownership is not taken into account for purposes of the 80% control test unless that person owns stock in each corporation of the putative brother-sister controlled group. These regulations provide the public with the guidance needed to comply with the law.

DATES: Generally, the amendments to the regulations under section 52 of the Code (relating to tax credits for employees) apply to taxable years beginning after December 31, 1976. The amendments to §1.414(b)-1 and §§1.414(c)-1 through -4 (relating to employees of trades or businesses under common control) generally are effective for plan years beginning after September 2, 1974 (subject to special rules for plans in existence on January 1, 1974). Sections 1.414(b)-1(c) and 1.414(c)-1 are amended to include references to section 408(k), which was added to the Code by the 1978 Act, and section 416, which was added by TEFRA. The additions of sections 408(k) and 416 are effective for taxable years beginning after December 31, 1978, and December 31, 1983, respectively. The amendments to §1.1563-1, which defines a controlled group of corporations, are effective for taxable years ending after December 31, 1970. However, §1.1563-1(d) provides that certain of the amendments will not apply retroactively if the result would be adverse to certain taxpayers.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains final amendments to the Income Tax Regulations (26 CFR Parts 1, 11, and 13) under section 414(b) and (c) of the Internal Revenue Code of 1954, relating to the aggregation of employees of members of a group of corporations, trades, or businesses that are under common control. The employees are treated as if employed by a single employer for purposes of applying certain rules relating to pension, profit-sharing, and stock bonus plans, enacted by the Employee Retirement Income Security Act of 1974 (88 Stat. 925). These regulations were published in proposed form in the FEDERAL REGISTER on November 5, 1975 (40 FR 51467), following the adoption of temporary regulations by Treasury decision, published on October 29, 1975 (40 FR 51435). The final regulations reflect amendments to section 414(b) and (c) made by section 152(d) of the 1978 Act (92 Stat. 2799) and section 240(c)(1) of TEFRA (96 Stat. 520), which made the provisions of section 414(b) and (c) applicable with respect to simplified employee pension plans under section 408(k) and to the special rules for top-heavy plans under section 416, respectively.

The final amendments to the regulations under section 1563, relating to the definition of a brother-sister group of corporations under common control, conform those regulations to a decision of the Supreme Court, *United States v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982). The amendments were proposed in a notice of rulemaking published in the FEDERAL REGISTER on November 16, 1983 (48 FR 52081) [1983-2 C.B. 735] Section 414(c) delegates authority to the Secretary to prescribe regulations for the determination of common control, limited to rules based upon principles similar to those which apply in the case of section 414(b). Common control in section 414(b) is defined by reference to section 1563(a), determined without regard to subsections (a)(4) (relating to certain insurance companies) and (e)(3)(C) (relating to attribution from an employee's trust described in section 401(a)). In addition, section 52 provides that, for purposes of certain jobs credits, employees of members of the same group of controlled corporations or other business organizations are treated as employed by a single employer. Regulations prescribed under section 52 are also based on principles similar to the rules under section 1563. Because the proposed and temporary regulations under section 414(b) and (c) and the regulations under section 52 paralleled the regulations under section 1563, the November 16, 1983 notice of rulemaking proposed conforming amendments to those regulations. Those amendments are also adopted by this Treasury decision.

COMMENTS

Comments were received in response to both notices of proposed rulemaking, but no public hearing was requested and none was held. Generally, the comments raised issues that had already been considered before publication of the two notices of proposed rulemaking.

Several comments contended that the regulations initially proposed under section 414(b) and (c) were partly inconsistent with the legislative history of ERISA. They objected that the proposed regulations aggregating employees of commonly controlled entities for various tests relating to coverage, vesting, and benefit limitations of employee plans could be interpreted to require complete uniformity among the separate plans established by individual organizations within the group. The proposed regulations, therefore, did not give effect to certain permissible variances described in the report of the House Ways and Means Committee. The comments suggested that the final regulations contain a provision to the effect that section 414(b) and (c) was "not intended to mean that all pension plans of a controlled group of corporations or partnerships must be exactly alike, or that a controlled group could not have pension plans for some corporations but not for others" (H.R. Rep. No. 779, 93d Cong., 2d Sess. 49 (1974)). This suggestion is not adopted. These regulations are inteded to be definitional only, and do not determine the actual treatment of the employees of a group defined as being a single employer. Thus, once a group of organizations is defined as a single employer, whether or not plans maintained by members of that group are qualified is tested under sections 401, 408(k), 410, 411, 415, and 416.

Other comments suggested that foreign organizations be ignored for purposes of section 414(b) and (c) and that only employees of organizations that are under common control and engaged in similar businesses be aggregated. These suggestions are also rejected as beyond the scope of definitional regulations.

Only one comment was received in response to the second notice of rulemaking. The comment noted that the decision in *Vogel Fertilizer* and the proposed amendments to the regulations result in the retroactive disaggregation of what were brother-sister controlled groups under the regulations before their amendment by this Treasury decision. Such disaggregation may decrease the tax liability of the individual organizations that no longer have to share a graduated rate schedule (or a single surtax exemption for taxable years beginning before January 1, 1979) or other deductions and credits. The comment suggested that the effects of this disaggregation be mitigated by allowing taxpayers to file amended returns, including claims for refunds, even for closed taxable years. This suggestion is not adopted because the period of limitation on filing a claim for credit or refund as specified in section 6511 cannot be extended by regulation.

DESCRIPTION OF CHANGES

Two changes have been made to the regulations as proposed. The first is to add references to sections 408(k) and 416 as provisions to which these regulations apply. These references were added to sections 414(b) and (c) by section 152(d) of the 1978 Act and section 240(c)(1) of TEFRA, respectively.

A new paragraph (f) has been added to §1.414(c)-3. That section generally provides that for purposes of determining control of an organization, certain defined interests will not be counted as either an "interest" or as "stock". However, in some situations the application of this general rule will result in the exclusion of an organization from a controlled group. The new paragraph provides that if an interest is owned by a person directly or constructively and that ownership results in the inclusion of an organization in a group of trades or businesses under common control, then that interest will not be treated as not outstanding under paragraph (b) or (c) of §1.414(c)-3 if the result would be that the organization would not be a member of a group of trades or businesses under common control. This rule, which is necessary to prevent the exclusion rules from being used to avoid common control status, is analogous to the rule of section 1563(f)(3)(C), which applies for purposes of determining whether a corporation is a component member of a controlled group of corporations. New paragraph (f) of §1.414(c)-3 is effective April 1, 1988.

REMOVAL OF TEMPORARY REGULATIONS

The final regulations under section 414(b) and (c) supersede the temporary regulations (§§11.414(c)-1 through 11.414(c)-5) under ERISA, published in the FEDERAL REGISTER on October 29, 1975 (40 FR 51435). This document, therefore, removes those temporary regulations.

Temporary regulations under the Tax Reform Act of 1969 (26 CFR §§13.16 and 13.16-1) were superseded by final regulations published on April 25, 1972 (37 FR 8068). As proposed in the notice of rulemaking published on November 16, 1983 (48 FR 52081), those temporary regulations are removed.

EXECUTIVE ORDER 12291 AND REGULATORY FLEXIBILITY ACT

The Commissioner of the Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. The Regulatory Flexibility Act does not apply to the portion of this document that adopts the amendments to the regulations proposed in 1975. The Internal Revenue Service has also concluded that the portion of the final regulations contained herein, which adopt the amendments proposed in 1983, are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

PAPERWORK REDUCTION ACT

The collection of information requirements contained in these regulations have been submitted to the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act of 1980. These requirements have been approved by OMB.

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1, Part 11, Part 13, and Part 602 are amended as follows:

Paragraph 1. The authority citation for Part 1 is amended to add the following citations:

Authority: 26 U.S.C. 7805. *** §1.52-1 also issued under 26 U.S.C. 52(b); §§1.414(c)-1 through 1.414(c)-5 also issued under 26 U.S.C. 414(c).

Par. 2. Section 1.52-1 is amended as follows:

1. Paragraphs (c)(1)(i) and (c)(1)(ii), are amended by removing "§11.414(c)-4(b)(1)" and adding instead "§1.414(c)-4(b)(1)".

2. Paragraph (d)(1)(i) is amended by removing §11.414(c)-4 and adding instead §1.414(c)-4 and by removing", singly or in combination,".

3. A new flush paragraph to read as set forth below is added at the end of paragraph (d)(1)(ii).

4. Paragraph (g) is amended by removing "§11.414(c)-3" from the first sentence and adding instead "§1.414(c)-3".

5. A new paragraph (h) is added at the end thereof to read as set forth below.

§1.52-1 Trades or businesses that are under common control.

* * * * *

(d) *Brother-sister group of trade or businesses under common control*—(1) *In general.* *** The five or fewer persons whose ownership is considered for purposes of the controlling interest requirement for each organization must be the same persons whose ownership is considered for purposes of the effective control requirement.

* * * * *

(b) *Transitional rule*—(1) *In general.* Paragraph (d) of this section, as amended by T.D. 8179, applies to all taxable years to which section 52(b) applies.

(2) *Election.* In the case of taxable years ending before March 2, 1988—

(i) If, pursuant to paragraph (b) of this section, an organization indicated in a timely filed return that it chose to be a member of a brother-sister group under common control, and it is not a member of such group because of the amendments to paragraph (d) of this section made by T.D. 8179, such organization may make the choice described in paragraph (b) of this section by filing an amended return on or before September 2, 1988 if such organization would otherwise still be a member of more than one group of trades or businesses under common control, and

(ii) If an organization

(A) Is a member of a brother-sister group of trades or businesses under common control under §1.52-1(d)(1), as in effect before amendment by T.D. 8179 ("old group") for such taxable year and

(B) Is not such a member for such taxable year because of the amendments made by such Treasury decision, such organization (whether or not a corporation) nevertheless will be treated as a member of such old group if all the organizations (whether or not corporations) that are members of the old group meet all the requirements of §1.1563-1(d)(3) with respect to such taxable year.

Par. 3. The following new sections are added immediately after §1.413-2.

§1.414(b)-1 Controlled group of corporations.

(a) *Definition of controlled group of corporations.* For purposes of this section, the term "controlled group of corporations" has the same meaning as is assigned to the term in section 1563(a) and the regulations thereunder, except that (1) the term "controlled group of corporations" shall not include an "insurance group" described in section 1563(a)(4), and (2) section 1563(e)(3)(C) (relating to stock owned by certain employees' trusts shall not apply. For purposes of this section, the term "members of a controlled group" means two or more corporations connected through stock ownership described in section 1563(a)(1), (2), or (3), whether or not such corporations are "component members of a controlled group" within the meaning of section 1563(b). Two or more corporations are members of a controlled group at any time such corporations meet the requirements of section 1563(a) (as modified by this paragraph). For purposes of this section, if a corporation is a member of more than one controlled group of corporations, such corporation shall be treated as a member of each controlled group.

(b) *Single plan adopted by two or more members.* If two or more members of a controlled group of corporations adopt a single plan for a plan year, then the minimum funding standard provided in section 412, the tax imposed by section 4971, and the applicable limitations provided by section 404(a) shall be determined as if such members were a single employer. In such a case, the amount of such items and the allocable portion attributable to each member shall be determined in the manner provided in regulations under sections 412, 4971, and 404(a).

(c) *Cross reference.* For rules relating to the application of sections 401, 408(k), 410, 411, 415, and 416 with respect to two or more trades or businesses which are under common control, see section 414(c) and the regulations thereunder.

§1.414(c)-1 Commonly controlled trades or businesses.

For purposes of applying the provisions of sections 401 (relating to qualified pension, profit-sharing, and stock bonus plans), 408(k) (relating to simplified employee pensions), 410 (relating to minimum participation standards), 411 (relating to minimum vesting standards), 415 (relating to limitations on benefits and contributions under qualified plans), and 416 (relating to top-heavy plans), all employees of two or more trades or businesses under common control within the meaning of §1.414(c)-2 for any period shall be treated as employed by a single employer. See sections 401, 408(k), 410, 411, 415, and 416 and the regulations thereunder for rules relating to employees of trades or businesses which are under common control. See §1.414(c)-5 for effective date.

§1.414(c)-2 Two or more trades or businesses under common control.

(a) *In general.* For purposes of this section, the term "two or more trades or businesses under common control" means any group of trades or businesses which is either a "parent-subsidiary group of trades or businesses under common control" as defined in paragraph (b) of this section, a "brother-sister group of trades or businesses under common control" as defined in paragraph (c) of this section, or a "combined group of trades or businesses under common control" as defined in paragraph (d) of this section. For purposes of this section and §§1.414(c)-3 and 1.414(c)-4, the term "organization" means a sole proprietorship, a partnership (as defined in section 7701(a)(2)), a trust, an estate, or a corporation.

(b) *Parent-subsidiary group of trades or businesses under common control*—(1) *In general.* The term "parent-subsidiary group of trades or businesses under common control" means one or more chains of organizations conducting trades or businesses connected through ownership of a controlling interest with a common parent organization if—

(i) A controlling interest in each of the organizations, except the common parent organization, is owned (directly and with the application of §1.414(c)-4(b)(1), relating to options) by one or more of the other organizations; and

(ii) The common parent organization owns (directly and with the application of §1.414(c)-4(b)(1), relating to options) a controlling interest in at least one of the other organizations, excluding, in computing such controlling interest, any direct ownership interest by such other organizations.

(2) *Controlling interest defined*—(i) *Controlling interest.* For purposes of paragraphs (b) and (c) of this section, the phrase "controlling interest" means:

(A) In the case of an organization which is a corporation, ownership of stock possessing at least 80 percent of total combined voting power of all classes of stock entitled to vote of such corporation or at least 80 percent of the total value of shares of all classes of stock of such corporation;

(B) In the case of an organization which is a trust or estate, ownership of an actuarial interest of a least 80 percent of such trust or estate;

(C) In the case of an organization which is a partnership, ownership of at least 80 percent of the profits interest or capital interest of such partnership; and

(D) In the case of an organization which is a sole proprietorship, ownership of such sole proprietorship.

(ii) *Actuarial interest.* For purposes of this section, the actuarial interest of each beneficiary of a trust or estate shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary. The factors and methods prescribed in §20.2031-7 or §20.2031-10 (Estate Tax Regulations), whichever is appropriate, for use in ascertaining the value of an interest in property for estate tax purposes shall be used for purposes of this subdivision in determining a beneficiary's acturial interest.

(c) Brother-sister group of trades or businesses under common control—(1) In general. The term "brother-sister group of trades or businesses under common control" means two or more organizations conducting trades or businesses if (i) the same, five or fewer persons who are individuals, estates, or trusts own (directly and with the application of §1.414(c)-4) a controlling interest in each organization, and (ii) taking into account the ownership of each such person only to the extent such ownership is identical with respect to each such organization, such persons are in effective control of each organization. The five or fewer persons whose ownership is considered for purposes of the controlling interest requirement for each organization must be the same persons whose ownership is considered for purposes of the effective control requirement.

(2) *Effective control defined.* For purposes of this paragraph, persons are in "effective control" of an organization if—

(i) In the case of an organization which is a corporation, such persons own stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of such corporation;

(ii) In the case of an organization which is a trust or estate, such persons own an aggregate actuarial interest of more than 50 percent of such trust or estate;

(iii) In the case of an organization which is a partnership, such persons own an aggregate of more than 50 percent of the profits interest or capital interest of such partnership; and

(iv) In the case of an organization which is a sole proprietorship one of such persons owns such sole proprietorship.

(d) *Combined group of trades or businesses under common control.* The term "combined group of trades or businesses under common control" means any group of three or more organizations, if (1) each such organization is a member of either a parent-subsidiary group of trades or businesses under common control or a brother-sister group of trades or businesses under common control, and (2) at least one such organization is the common parent organization of a parent-subsidiary group of trades or businesses under common control and is also a member of a brother-sister group of trades or businesses under common control.

(e) *Examples.* The definitions of parent-subsidiary group of trades or businesses under common control, brother-sister group of trades or businesses under common control, and combined group of trades or businesses under common control may be illustrated by the following examples.

Example (1) (a) The ABC partnership owns stock possessing 80 percent of the total combined voting power of all classes of stock entitled to vote of S corporation. ABC partnership is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of the ABC partnership and S corporation.

(b) Assume the same facts as in (a) and assume further that S owns 80 percent of the profits interest in the DEF Partnership. The ABC Partnership is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of the ABC Partnership, S Corporation, and the DEF Partnership. The result would be the same if the ABC Partnership, rather than S, owned 80 percent of the profits interest in the DEF Partnership.

Example (2) L Corporation owns 80 percent of the only class of stock of T Corporation, and T, in turn, owns 40 percent of the capital interest in the GHI Partnership. L also owns 80 percent of the only class of stock of N Corporation and N, in turn, owns 40 percent of the capital interest in the GHI Partnership. L is the common parent of parent-subsidiary group of trades or businesses under common control consisting of L Corporation, T Corporation, N Corporation, and the GHI Partnership.

Example (3). ABC Partnership owns 75 percent of the only class of stock of X and Y Corporations; X owns all the remaining stock of Y, and Y owns all the remaining stock of X. Since interorganization ownership is excluded (that is, treated as not outstanding) for purposes of determining whether ABC owns a controlling interest of at least one of the other organizations. ABC is treated as the owner of stock possessing 100 percent of the voting power and value of all classes of stock of X and of Y for purposes of paragraph (b)(1)(ii) of this section. Therefore, ABC is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of the ABC Partnership, X Corporation, and Y Corporation.

Example (4). Unrelated individuals A, B, C, D, E, and F own an interest in sole proprietorship A, a capital interest in the GHI Partnership, and stock of corporations M, W, X, Y, and Z (each of which has only one class of stock outstanding) in the following proportions:

Individuals	Organizations						
	A	GHI	M	W	X	Y	Z
A	100%	50%	100%	60%	40%	20%	60%
B	—	40%	—	15%	40%	50%	30%
C	—	—	—	—	10%	10%	10%
D	—	—	—	25%	—	20%	—
E	—	10%	—	—	10%	—	—
	100%	100%	100%	100%	100%	100%	100%

Under these facts the following four brother-sister groups of trades or businesses under common control exist: GHI, X and Z; X, Y and Z; W and Y; A and M. In the case of GHI, X, and Z, for example, A and B together have effective control of each organization because their combined identical ownership of GHI, X and Z is greater than 50%. (A's identical ownership of GHI, X and Z is 40% because A owns at least a 40% interest in each organization. B's identical ownership of GHI, X and Z is 30% because B owns at least a 30% interest in each organization.) A and B (the persons whose ownership is considered for purposes of the effective control requirement) together own a controlling interest in each organization because they own at least 80% of the capital interest of partnership GHI and at least 80% of the total combined voting power of corporations X and Z. Therefore, GHI, X and Z comprise a brother-sister group of trades or businesses under common control. Y is not a member of this group because neither the effective control requirement nor the 80% controlling interest requirement are met. (The effective control requirement is not met because A's and B's combined identical ownership in CHI, X, Y and Z (20% for A and 30% for B) does not exceed 50%. The 80% controlling interest test is not met because A and B together only own 70% of the total combined voting power of the stock of Y.) A and M are not members of this group because B owns no interest in either organization and A's ownership of GHI, X and Z, considered alone, is less than 80%.

Example (5). The outstanding stock of corporations U and V, which have only one class of stock outstanding, is owned by the following unrelated individuals:

Individuals	Corporations	
	U	V
A	12%	12%
B	12%	12%
C	12%	12%
D	12%	12%
E	13%	13%
F	13%	13%
G	13%	13%
H	13%	13%
	100%	100%

Any group of five of the shareholders will own more than 50 percent of the stock in each corporation, in identical holdings. However, U and V are not members of a brother-sister group of trades or businesses under common control because at least 80 percent of the stock of each corporation is not owned by the same five of fewer persons.

Example (6). A, an individual, owns a controlling interest in ABC Partnership and DEF Partnership. ABC, in turn, owns a controlling interest in X Corporation. Since ABC, DEF, and X are each members of either a parent-subsidiary group or a brother-sister group of trades or businesses under common control, and ABC is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of ABC and X, and also a member of a brother-sister group of trades or businesses under common control consisting of ABC and DEF, ABC Partnership, DEF Partnership, and X Corporation are members of the same combined group of trades or businesses under common control.

§1.414(c)-3 Exclusion of certain interests or stock in determining control.

(a) *In general.* For purposes of §1.414 (c)-2(b)(2)(i) and (c)(2), the term "interest" and the term "stock" do not include an interest which is treated as not outstanding under paragraph (b) of this section in the case of a parent-subsidiary group of trades or businesses under common control or under paragraph (c) of this section in the case of a brother-sister group of trades or businesses under common control. In addition, the term "stock" does not include treasury stock or nonvoting stock which is limited and preferred as to dividends. For definitions of certain terms used in this section, see paragraph (d) of this section.

(b) *Parent-subsidiary group of trades or businesses under common control*—(1) *In general.* If an organization (hereinafter in this section referred to as "parent organization") owns (within the meaning of paragraph (b)(2) of this section)—

(i) In the case of a corporation, 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of such corporation.

(ii) In the case of a trust or an estate, an actuarial interest (within the meaning of §1.414(c)—2(b)(2)(ii)) of 50 percent or more of such trust or estate, and

(iii) In the case of a partnership, 50 percent or more of the profits or capital interest of such partnership, then for purposes of determining whether the parent organization or such other organization (hereinafter in this section referred to as "subsidiary organization") is a member of a parent-subsidiary group of trades or businesses under common control, an interest in such subsidiary organization excluded under paragraph (b)(3), (4), (5), or (6) of this section shall be treated as not outstanding.

(2) *Ownership.* For purposes of paragraph (b)(1) of this section, a parent organization shall be considered to own an interest in or stock of another organization which it owns directly or indirectly with the application of paragraph (b)(1) of §1.414(c)-4 and—

(3) *Plan of deferred compensation.* An interest which is an interest in or stock of the subsidiary organization held by a trust which is part of a plan of deferred compensation (within the meaning of section 406(a)(3) and the regulations thereunder) for the benefit of the employees of the parent organization or the subsidiary organization shall be excluded.

(4) *Principal owners, officers, etc.* An interest which is an interest in or stock of the subsidiary organization owned (directly and with the application of §1.414(c)-4) by an individual who is a principal owner, officer, partner, or fiduciary of the parent organization shall be excluded.

(5) *Employees.* An interest which is an interest in or stock of the subsidiary organization owned (directly and with the application of §1.414(c)-4) by an employee of the subsidiary organization shall be excluded if such interest or such stock is subject to conditions which substantially restrict or limit the employee's right (or if the employee constructively owns such interest or such stock, the direct or record owner's right) to dispose of such interest or such stock and which run in favor of the parent or subsidiary organization.

(6) *Controlled exempt organization.* An interest which is an interest in or stock of the subsidiary organization shall be excluded if owned (directly and with the application of §1.414(c)-4) by an organization (other than the parent organization):

(i) To which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies, and

(ii) Which is controlled directly or indirectly (within the meaning of paragraph (d)(7) of this section) by the parent organization or subsidiary organization, by an individual, estate, or trust that is a principal owner of the parent organization, by an officer, partner, or fiduciary of the parent organization, or by any combination thereof.

(c) *Brother-sister group of trades or businesses under common control*—(1) *In general.* If five or fewer persons (hereinafter in this section referred to as "common owners") who are individuals, estates, or trusts own (directly and with the application of §1.414(c)-4)—

(i) In the case of a corporation, 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of such corporation,

(ii) In the case of a trust or an estate, an actuarial interest (within the meaning of §1.414(c)-2(b)(2)(ii)) of 50 percent or more of such trust or estate, and

(iii) In the case of a partnership, 50 percent or more of the profits or capital interest of such partnership, then for purposes of determining whether such organization is a member of a brother-sister group of trades or businesses under common control, an interest in such organization excluded under paragraph (c)(2), (3), or (4) of this section shall be treated as not outstanding.

(2) *Exempt employees' trust.* An interest which is an interest in or stock of such organization held by an employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be excluded if

such trust is for the benefit of the employees of such organization.

(3) *Employees.* An interest which is an interest in or stock of such organization owned (directly and with the application of §1.414(c)–4) by an employee of such organization shall be excluded if such interest or stock is subject to conditions which run in favor of a common owner of such organization or in favor of such organization and which substantially restrict or limit the employee's right (or if the employee constructively owns such interest or stock, the direct or record owner's right) to dispose of such interest or stock.

(4) *Controlled exempt organization.* An interest which is an interest in or stock of such organization shall be excluded if owned (directly and with the application of §1.414(c)–4) by an organization:

(i) To which section 501(c)(3) (relating to certain educational and charitable organizations which are exempt from tax) applies, and

(ii) Which is controlled directly or indirectly (within the meaning of paragraph (d)(7) of this section) by such organization, by an individual, estate, or trust that is a principal owner of such organization, by an officer, partner, or fiduciary of such organization, or by any combination thereof.

(d) *Definitions*—(1) *Employee.* For purposes of this section, the term "employee" has the same meaning such term is given in section 3306(i) of the Code (relating to definitions for purposes of the Federal Unemployment Tax Act).

(2) *Principal owner.* For purposes of this section, the term "principal owner" means a person who owns (directly and with the application of §1.414(c)–4)—

(i) In the case of a corporation, 5 percent or more of the total combined voting power of all classes of stock entitled to vote in such corporation or 5 percent of more of the total value of shares of all classes of stock of such corporation:

(ii) In the case of a trust or estate, an actuarial interest of 5 percent or more of such trust or estate; or

(iii) In the case of a partnership, 5 percent or more of the profits or capital interest of such partnership.

(3) *Officer.* For purposes of this section, the term "officer" includes the president, vice-presidents, general manager, treasurer, secretary, and comptroller of a corporation, and any other person who performs duties corresponding to those normally performed by persons occupying such positions.

(4) *Partner.* For purposes of this section, the term "partner" means any person defined in section 7701(a)(2) (relating to definitions of partner).

(5) *Fiduciary.* For purposes of this section and §1.414(c)–4, the term, "fiduciary" has the same meaning as such term is given in section 7701(a)(6) and the regulations thereunder.

(6) *Substantial conditions.* (i) *In general.* For purposes of this section, an interest in or stock of an organization is subject to conditions which substantially restrict or limit the right to dispose of such interest or stock and which run in favor of another person if the condition extends directly or indirectly to such person preferential rights with respect to the acquisition of the direct owner's (or the record owner's) interest or stock. For a condition to be in favor of another person it is not necessary that such person be extended a discriminatory concession with respect to price. A right of first refusal with respect to an interest or stock in favor of another person is a condition which substantially restricts or limits the direct or record owner's right of disposition which runs in favor of such person. Further, any legally enforceable condition which prohibits the direct or record owner from disposing of his or her interest or stock without the consent of another person will be considered to be a substantial limitation running in favor of such person.

(ii) *Special rule.* For purposes of paragraph (c)(3) of this section only, if a condition which restricts or limits an employee's right (or direct or record owner's right) to dispose of his or her interest or stock also applies to the interest or stock in such organization held by a common owner pursuant to a bona fide reciprocal purchase arrangement, such condition shall not be treated as a substantial limitation or restriction. An example of a reciprocal purchase arrangement is an agreement whereby a common owner and the employee are given a right of first refusal with respect to stock of the employer corporation owned by the other party. If, however, the agreement also provides that the common owner has the right to purchase the stock of the employer corporation owned by the employee in the event the corporation should discharge the employee for reasonable cause, the purchase arrangement would not be reciprocal within the meaning of this subdivision.

(7) *Control.* For purposes of paragraphs (b)(6) and (c)(4) of this section, the term "control" means control in fact. The determination of whether there exists control in fact will depend upon all of the facts and circumstances of each case, without regard to whether such control is legally enforceable and irrespective of the method by which such control is exercised or exercisable.

(e) *Examples.* The provision of this section may be illustrated by the following examples:

Example (1). ABC Partnership owns 70 percent of the capital interest and of the profits interest in the DEF Partnership. The remaining capital interest and profits interest in DEF is owned as follows: 4 percent by A (a general partner in ABC), and 26 percent by D (a limited partner in ABC). ABC satisfies the 50-percent capital interest or profits interest ownership requirement of paragraph (b)(1)(iii) of this section with respect to DEF. Since A and D are partners of ABC, under paragraph (b)(4) of this section the capital and profits interests in DEF owned by A and D are treated as not outstanding for purposes of determining whether ABC and DEF are members of a parent-subsidiary group of trades or businesses under common control under §1.414(c)–2(b) Thus, ABC is considered to own 100 percent (7 ÷ 70) of the capital interest and profits interest in DEF. Accordingly, ABC and DEF are members of a parent-subsidiary group of trades or businesses under common control.

Example (2). Assume the same facts as in example (1) and assume further than A owns 15 shares of the 100 shares of the only class of stock of S Corporation and DEF Partnership owns 75 shares of such stock. ABC satisfies the 50 percent stock requirement of paragraph (b)(1)(l) of this section with respect to S since ABC is considered as owning 52.5 percent (70 percent × 75 percent) of the S stock with the application of §1.414(c)–4(b)(2). Since A is a partner of ABC, the stock owned by A is treated as not outstanding for purposes of determining whether S is a member of a parent-subsidiary group of trades or businesses under common control. Thus, DEF Partnership is considered to own stock possessing 88.2 percent (75 ÷ 85) of the voting power and value of the S Stock. Accordingly, ABC Partnership, DEF Partnership, and S Corporation are members of a parent-subsidiary group of trades or businesses under common control.

Example (*3*). ABC Partnership owns 60 percent of the only class of stock of Corporation Y. D, the president of Y, owns the remaining 40 percent of the stock of Y. D has agreed that if she offers her stock in Y for sale she will first offer the stock to ABC at a price equal to the fair market value of the stock on the first date the stock is offered for sale. Since D is an employee of Y within the meaning of section 3306(i) of the Code and her stock in Y is subject to a condition which substantially restricts or limits her right to dispose of such stock and runs in favor of ABC Partnership, under paragraph (b)(5) of this section such stock is treated as not outstanding for purposes of determining whether ABC and Y are members of a parent-subsidiary group of trades or businesses under common control. Thus, ABC Partnership is considered to own stock possessing 100 percent of the voting power and value of the stock of Y. Accordingly, ABC Partnership and Y Corporation are members of a parent-subsidiary group of trades or businesses under common control. The result would be the same if D's husband, instead of D, owned directly the 40 percent stock interest in Y and such stock was subject to a right of first refusal running in favor of ABC Partnership.

(f) *Exception*—(1) *In general.* If an interest in an organization (including stock of a corporation) is owned by a person directly or with the application of the rules of paragraph (b) of §1.414(c)-4 and such ownership results in the membership of that organization in a group of two or more trades or businesses under common control for any period, then the interest will not be treated as an excluded interest under paragraph (b) or (c) of this section if the result of applying such provisions is that the organization is not a member of a group of two or more trades or businesses under common control for the period.

(2) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. Corporation P owns directly 50 of the 100 shares of the only class of stock of corporation S. A, an officer of P, owns directly 30 shares of S stock which P has an option to acquire. If, under paragraph (b)(4) of this section, the 30 shares owned directly by A are treated as not outstanding, P would be treated as owning stock possessing only 71 percent (50/70) of the total voting power and value of S stock, and S should not be a member of a parent-subsidiary group of trades or businesses under common control. However, because the 30 shares owned by A that P has an option to purchase are considered as owned by P under paragraph (b)(2) of this section, and that ownership plus P's direct ownership of 50 shares result in S's membership in a parent-subsidiary group of trades or businesses under common control for 1985, the provisions of this paragraph apply. Therefore, A's stock is not treated as an excluded interest and S is a member of a parent-subsidiary group consisting of P and S.

§1.414(c)- Rules for determining ownership.

(a) *In general.* In determining the ownership of an interest in an organization for purposes of §1.414(c)-2 and §1.414(c)-3, the constructive ownership rules of paragraph (b) of this section shall apply, subject to the operating rules contained in paragraph (c). For purposes of this section the term "interest" means: in the case of a corporation, stock; in the case of a trust or estate, an actuarial interest; in the case of a partnership, an interest in the profits or capital; and in the case of a sole proprietorship, the proprietorship.

(b) *Constructive ownership*—(1) *Options.* If a person has an option to acquire any outstanding interest in an organization, such interest shall be considered as owned by such person. For this purpose, an option to acquire an option, and each one of a series of such options, shall be considered as an option to acquire such interest.

(2) *Attribution from partnerships*—(i) *General.* An interest owned, directly or indirectly, by or for a partnership shall be considered as owned by any partner having an interest of 5 percent or more in either the profits or capital of the partnership in proportion to such partner's interest in the profits or capital, whichever such proportion is greater.

(ii) *Example.* The provisions of paragraph (b)(2)(i) of this section may be illustrated by the following example:

Example. A, B, and C, unrelated individuals, are partners in the ABC Partnership. The partners' interests in the capital and profits of ABC are as follows:

[In percent]

Partner	Capital	Profits
A	36	25
B	60	71
C	4	4

The ABC Partnership owns the entire outstanding stock (100 shares) of X Corporation. Under paragraph (b)(2)(i) of this section, A is considered to own the stock of X owned by the partnership in proportion to his interest in capital (36 percent) or profits (25 percent), whichever such proportion is greater. Therefore, A is considered to own 36 shares of X stock. Since B has a greater interest in the profits of the partnership than in the capital, B is considered to own X stock in proportion to his interest in such profits. Therefore, B is considered to own 71 shares of X stock. Since C does not have an interest of 5 percent or more in either the capital or profits of ABC, he is not considered to own any shares of X stock.

(3) *Attribution from estates and trusts*—(i) *In general.* An interest in an organization (hereinafter called an "organization interest") owned, directly or indirectly, by or for an estate or trust shall be considered as owned by any beneficiary of such estate or trust who has an actuarial interest of 5 percent or more in such organization interest, to the extent of such actuarial interest. For purposes of this subparagraph, the actuarial interest of each beneficiary shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary and the maximum use of the organization interest to satisfy the beneficiary's rights. A beneficiary of an estate or trust who cannot under any circumstances receive any part of an organization interest held by the estate or trust, including the proceeds from the disposition thereof, or the income therefrom, does not have an actuarial interest in such organization interest. Thus, where stock owned by a decedent's estate has been specifically bequeathed to certain beneficiaries and the remainder of the estate has been specifically bequeathed to other beneficiaries, the stock is attributable only to the beneficiaries to whom it is specifically bequeathed. Similarly a remainderman of a trust who cannot under any circumstances receive any interest in the stock of a corporation which is a part of the corpus of the trust (including any accumulated income therefrom or the proceeds from a disposition thereof) does not have an actuarial interest in such stock. However, an income beneficiary of a trust does have an actuarial interest in stock if he has any right to the income from such stock even though under the terms of the trust instrument such stock can never be distributed to him. The factors and methods prescribed in §20.2031-7 or §20.2031-10 (Estate Tax Regulations), whichever is appropriate for use in ascertaining the value of an interest in property for estate tax purposes shall be used for purposes of this subdivision in determining a beneficiary's actuarial interest in an organization interest owned directly or indirectly by or for an estate or trust.

(ii) *Special rules for estates.* (A) For purposes of this paragraph (b)(3) with respect to an estate, property of a decedent shall be considered as owned by his or her estate if such property is subject to administration by the executor or administrator for the purposes of paying claims against the estate and expenses of administration notwithstanding that, under local law, legal title to such property vests in the decedent's heirs, legatees or devisees immediately upon death.

(B) For purposes of this paragraph (b)(3) with respect to an estate, the term "beneficiary" includes any person entitled to receive property of a decedent pursuant to a will or pursuant to laws of descent and distribution.

(C) For purposes of this paragraph (b)(3) with respect to an estate, a person shall no longer be considered a beneficiary of an estate when all the property to which he or she is entitled has been received by him or her, when he or she no longer has a claim against the estate arising out of having been a beneficiary, and when there is only a remote possibility that it will be necessary for the estate to see the return of property from him or her or to seek payment from him or her by contribution or otherwise to satisfy claims against the estate or expenses of administration.

(iii) *Grantor trusts, etc.* An interest owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E, part I, subchapter J of the Code (relating to grantors and others treated as substantial owners) is considered as owned by such person.

(4) *Attribution from corporations*—(i) *General.* An interest owned, directly or indirectly, by or for a corporation shall be considered as owned by any person who owns (directly and, in the case of a parent-subsidiary group of trades or businesses under common control, with the application of paragraph (b)(1) of this section, or in the case of a brother-sister group of trades or business under common control, with the application of this section), 5 percent or more in value of the stock in that proportion which the value of the stock which such person so owns bears to the total value of all the stock in such corporation.

(ii) *Example.* The provisions of paragraph (b)(4)(i) of this section may be illustrated by the following example:

Example. B, an individual, owns 60 of the 100 shares of the only class of outstanding stock of corporation P. C, an individual, owns 4 shares of the P stock, and corporation X owns 36 shares of the P stock. Corporation P owns, directly and indirectly, 50 shares of the stock of corporation S. Under this subparagraph, B is considered to own 30 shares of the S stock (60/100 × 50), and X is considered to own 18 shares of S stock (36/100 × 50). Since C does not own 5 percent or more in the value of P stock, he is not considered as owning any of the S stock owned by P. If in this example, C's wife had owned directly 1 share of the P stock, C and his wife would each be considered as owning 5 shares of the P stock, and therefore C and his wife would be considered as owning 2.5 shares of the S stock (5/100 × 50).

(5) *Spouse*—(i) *General rule.* Except as provided in paragraph (b)(5)(ii) of this section, an individual shall be considered to own an interest owned, directly or indirectly, by or for his or her spouse, other than a spouse who is legally separated from the individual under a decree of divorce, whether interlocutory or final, or a decree of separate maintenance.

(ii) *Exception.* An individual shall not be considered to own an interest in an organization owned, directly or indirectly, by or for his or her spouse on any day of a taxable year of such organization, provided that each of the following conditions are satisfied with respect to such taxable year:

(A) Such individual does not, at any time during such taxable year, own directly any interest in such organization;

(B) Such individual is not a member of the board of directors, a fiduciary, or an employee of such organization and does not participate in the management of such organization at any time during such taxable year;

(C) Not more than 50 percent of such organization's gross income for such taxable year was derived from royalties, rents, dividends, interest, and annuities; and

(D) Such interest in such organization is not, at any time during such taxable year, subject to conditions which substantially restrict or limit the spouse's right to dispose of such interest and which run in favor of the individual or the individual's children who have not attained the age of 21 years. The principles of §1.414(c)–3(d)(6)(i) shall apply in determining whether a condition is a condition described in the preceding sentence.

(iii) *Definitions.* For purposes of paragraph (b)(5)(ii)(C) of this section, the gross income of an organization shall be determined under section 61 and the regulations thereunder. The terms "interest", "royalties", "rents", "dividends", and "annuities" shall have the same meaning such terms are given for purposes of section 1244(c) and §1.1244(c)–1(e)(1).

(6) *Children, grandchildren, parents, and grandparents*—(i) *Children and parents.* An individual shall be considered to own an interest owned, directly or indirectly, by or for the individual's children who have not attained the age of 21 years, and if the individual has not attained the age of 21 years, an interest owned, directly or indirectly, by or for the individual's parents.

(ii) *Children, grandchildren, parents, and grandparents.* If an individual is in effective control (within the meaning of §1.414(c)–2(c)(2)), directly and with the application of the rules of this paragraph without regard to this subdivision, of an organization, then such individual shall be considered to own an interest in such organization owned, directly or indirectly, by or for the individual's parents, grandparents, grandchildren, and children who have attained the age of 21 years.

(iii) *Adopted children.* For purposes of this section, a legally adopted child of an individual shall be treated as a child of such individual.

(iv) *Example.* The provisions of this subparagraph (6) may be illustrated by the following example:

Example—(A) *Facts.* Individual F owns directly 40 percent of the profits interest of the DEF Partnership. His son, M, 20 years of age, owns directly 30 percent of the profits interest of DEF, and his son, A, 30 years of age, owns directly 20 percent of the profits interest of DEF. The 10 percent remaining of the profits interest and 100 percent of the capital interest of DEF is owned by an unrelated person.

(B) *F's ownership.* F owns 40 percent of the profits interest in DEF directly and is considered to own the 30 percent profits interest owned directly by M. Since, for purposes of the effective control test contained in paragraph (b)(6)(ii) of this section, F is treated as owning 70 percent of the profits interest of DEF, F is also considered as owning the 20 percent profits interest of DEF owned by his adult son, A. Accordingly, F is considered as owning a total of 90 percent of the profits interest in DEF.

(C) *M's ownership.* Minor son, M, owns 30 percent of the profits interest in DEF directly, and is considered to own the 40 percent profits interest owned directly by his father, F. However, M is not considered to own the 20 percent profits interest of DEF owned directly by his brother, A, and constructively by F, because an interest constructively owned by F by reason of family attribution is not considered as owned by him for purposes of making another member of his family the constructive owner of such interest. (See paragraph (c)(2) of this section.) Accordingly, M is considered as owning a total of 70 percent of the profits interest of the DEF Partnership.

(D) *A's ownership.* Adult son, A, owns 20 percent of the profits interest in DEF directly. Since, for purposes of determining whether A effectively controls DEF under paragraph (b)(6)(ii) of this section, A is treated as owning only the percentage of profits interest he owns directly, he does not satisfy the condition precedent for the attribution of the DEF profits interest from his father. Accordingly, A is considered as owning only the 20 percent profits interest in DEF which he owns directly.

(c) *Operating rules*—(1) *In general.* Except as provided in paragraph (c)(2) of this section, an interest constructively owned by a person by reason of the application of paragraph (b)(1), (2), (3), (4), (5), or (6) of this section shall, for the purposes of applying such paragraph, be treated as actually owned by such person.

(2) *Members of family.* An interest constructively owned by an individual by reason of the application of paragraph (b)(5) or (6) of this section shall not be treated as owned by such individual for purposes of again applying such subparagraphs in order to make another the constructive owner of such interest.

(3) *Precedence of option attribution.* For purposes of this section, if an interest may be considered as owned under paragraph (b)(1) of this section (relating to option attribution) and under any other subparagraph of paragraph (b) of this section, such interest shall be considered as owned by such person under paragraph (b)(1) of this section.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). A, 30 years of age, has a 90 percent interest in the capital and profits of DEF Partnership. DEF owns all the outstanding stock of corporation X and X owns 60 shares of the 100 outstanding shares of corporation Y. Under paragraph (c)(1) of this section, the 60 shares of Y constructively owned by DEF by reason of paragraph (b)(4) of this section are treated as actually owned by DEF for purposes of applying paragraph (b)(2) of this section. Therefore, A is considered as owning 54 shares of the Y stock (90 percent of 60 shares).

Example (2). Assume the same facts as in example (1). Assume further that B, who is 20 years of age and the brother of A, directly owns 40 shares of Y stock. Although the stock of Y owned by B is considered as owned by C (the father of A and B) under paragraph (b)(6)(i) of this section, under paragraph (c)(2) of this section such stock may not be treated as owned by C for purposes of applying paragraph (b)(6)(ii) of this section in order to make A the constructive owner of such stock.

Example (3). Assume the same facts as in example (2), and further assume that C has an option to acquire the 40 shares of Y stock owned by his son, B. The rule contained in paragraph (c)(2) of this section does not prevent the reattribution of such 40 shares to A because, under paragraph (c)(3) of this section, C is considered as owning the 40 shares by reason of option attribution and not by reason of family attribution. Therefore, since A is in effective control of Y under paragraph (b)(6)(ii) of this section, the 40 shares of Y stock constructively owned by C are reattributed to A. A is considered as owning a total of 94 shares of Y stock.

§1.414(c)-5 Effective date.

(a) *General rule.* Except as provided in paragraph (b), (c), (e), or (f) of this section, the provisions of §1.414(b)-1 and §§1.414(c)-1 through 1.414(c)-4 shall apply for plan years beginning after September 22, 1974.

(b) *Existing plans.* In the case of a plan in existence on January 1, 1974, unless paragraph (c) of this section applies, the provisions of §1.414(b)-1 and §§1.414(c)-1 through 1.414(c)-4 shall apply for plan years beginning after December 31, 1975. For definition of the term "existing plan", see §1.410(a)-2(c).

(c) *Existing plans electing new provisions.* In the case of a plan in existence on January 1, 1974, for which the plan administrator makes an election under §1.410(a)-2(d), the provisions of §1.414(b)-1 and §§1.414(c)-1 through 1.414(c)-4 shall apply to the plan years elected under §1.410(a)-2(d).

(d) *Application.* For purposes of the Employee Retirement Income Security Act of 1974, the provisions of §1.414(b)-1 and §§1.414(c)-1 through 1.414(c)-4 do not apply for any period of time before the plan years described in paragraph (a), (b), or (c) of this section, whichever is applicable.

(e) *Special rule.* Notwithstanding paragraph (a), (b), or (c) of this section, §1.414(c)-3(f) is effective April 1, 1988.

(f) *Transitional rule*—(1) *In general.* The amendments made by T.D. 8179 apply to the plan years or period described in paragraphs (a), (b), or (c) of this section, whichever is applicable.

(2) *Exception.* In the case of a plan year or period beginning before March 2, 1988, if an organization—

(i) Is a member of a brother-sister group of trades or businesses under common control under §11.414(c)-2(c), as in effect before removal by T.D. 8179 ("old group"), for such plan year or period, and

(ii) Is not such a member for such plan year or period because of the amendments made by such Treasury decision, such member (whether or not a corporation) nevertheless will be treated as a member of such old group for purposes of section 414(c) for that plan year or period to the extent provided in §1.1563-1(d)(2). Also, such member will be treated as a member of an old group for all purposes of the Code for such plan year or period if all the organizations (whether or not corporations) that are members of the old groups meet all the requirements of §1.1563-1(d)(3) with respect to such plan year or period.

Par. 4. Section 1.1563-1 is amended as follows:

1. Paragraph (a)(3)(i) is amended by deleting ", singly or in combination," and by adding a new flush paragraph at the end of (a)(3)(i)(b) as set forth below.

2. Paragraph (a)(3) is amended by revising Examples (1) and (2) and by adding new Examples (3) and (4) in paragraph (a)(3)(ii) and by paragraph (a)(3)(iii) as set forth below.

3. Paragraph (c)(2)(iv) is amended by revising the charts in Examples (1) and (2) as set forth below.

4. Paragraph (d) is added to read as set forth below:

§1.1563-1 Definition of controlled group of corporations and component members.

(a) *Controlled group of corporations.* . . .

(3) *Brother-sister controlled group*

(i) . . .

The five or fewer persons whose stock ownership is considered for purposes of the 80 percent requirement must be the same persons whose stock ownership is considered for purposes of the more-than-50 percent requirement.

* * * * *

(ii) ***

Example (1). The outstanding stock of corporations P, Q, R, S, and T, which have only one class of stock outstanding, is owned by the following unrelated individuals:

Individuals	*Corporations* P	Q	R	S	T	Identical Ownership
A	55%	51%	55%	55%	55%	51%
B	45%	49%	—	—	—	(45% in P & Q)
C	—	—	45%	—	—	—
D	—	—	—	45%	—	—
E	—	—	—	—	45%	—
Total	100%	100%	100%	100%	100%	

Corporations P and Q are members of a brother-sister controlled group of corporations. Although the more-than-50 percent identical ownership requirement is met for all 5 corporations, corporations R, S, and T are not members because at least 80 percent of the stock of each of those corporations is not owned by the same 5 or fewer persons whose stock ownership is considered for purposes of the more-than-50 percent identical ownership requirement.

Example (2). The outstanding stock of corporations U and V, which have only one class of stock outstanding, is owned by the following unrelated individuals:

Individuals	Corporations U (Percent)	C (percent)
A............	12	12
B............	12	12
C............	12	12
D............	12	12
E............	13	13
F............	13	13
G............	13	13
H............	13	13
....	100	100

Any group of five of the shareholders will own more than 50 percent of the stock in each corporation, in identical holdings. However, U and V are not members of a brother-sister controlled group because at least 80 percent of the stock of each corporation is not owned by the same five or fewer persons.

Example (3). Corporations X and Y each have two classes of stock outstanding, voting common and non-voting common. (None of this stock is excluded from the definition of stock under section 1563(c).) Unrelated individuals A and B own the following percentages of the class of stock entitled to vote (voting) and of the total value of shares of all classes of stock (value) in each of corporations X and Y:

Individuals	Corporations X	Y
A	100% voting 60% value	75% voting 60% value
B	0% voting 10% value	25% voting 10% value

No other shareholder of X owns (or is considered to own) any stock in Y. X and Y are a brother-sister controlled group of corporations. The group meets the more-than-50 percent ownership requirement because A and B own more than 50 percent of the total value of shares of all classes of stock of X and Y in identical holdings. (The group also meets the more-than-50 percent ownership requirement because of A's voting stock ownership.) The group meets the 80 percent requirement because A and B own at least 80 percent of the total combined voting power of all classes of stock entitled to vote.

Example (4). Assume the same facts as in example (3) except that the value of the stock owned by A and B is not more than 30 percent of the total value of shares of all classes of stock of each corporation in identical holdings. X and Y are not a brother-sister controlled group of corporations. The group meets the more-than-50 percent ownership requirement because A owns more than 50 percent of the total combined voting power of the voting stock of each corporation. For purposes of the 80 percent requirement, B's voting stock in Y cannot be combined with A's voting stock in Y since B, who does not own any voting stock in X, is not a person whose ownership is considered for purposes of the more-than-50 percent requirement. Because no other shareholder owns stock in both X and Y, these other shareholders' stock ownership is not counted towards meeting either the more-than-50 percent ownership requirement or the 80-percent ownership requirement.

(iii) Paragraph (a)(3) of this section, as amended by T.D. 8179 of this Treasury decision, applies to taxable years ending on or after December 31, 1970. See, however, the transitional rule in paragraph (d) of this section.

* * * * *

(c) *Overlapping groups.* ***

(2) *Brother-sister controlled groups.* ***

(iv) ***

Example (1). ***

Individuals	Corporations M	N	P
A	55%	40%	5%
B	40%	20%	40%
C	5%	40%	55%

* * *

Example (2). ***

Individuals	Corporations S	T	W	X	Z
D	52%	52%	52%	52%	52%
E	40%	2%	2%	2%	2%
F	2%	40%	2%	2%	2%
G	2%	2%	40%	2%	2%
H	2%	2%	2%	40%	2%
I	2%	2%	2%	2%	40%

* * * * *

(d) *Transitional rules*—(1) *In general.* Treasury decision 8179 amended paragraph (a)(3) of this section to revise the definition of a brother-sister controlled group of corporations. In general, those amendments are effective for taxable years ending on or after December 31, 1970.

(2) *Limited nonretroactivity.* (i) Under the authority of section 7805 (b), the Internal Revenue Service will treat an old group as a brother-sister controlled group of corporations for purposes of applying sections 401, 404(a), 406(k), 409A, 410, 411, 412, 414, 415, and 4971 of the Code and sections 202, 203, 204, and 302 of the Employment Retirement Income Security Act of 1974 (ERISA) in a plan year or taxable year beginning before March 2, 1988 to the extent necessary to prevent an adverse effect on any old member (or any other corporation), or on any plan or other entity described in such sections (including plans, etc., of corporations not part of such old group), that would result solely from the retroactive effect of the amendment to this section by T.D. 8179. An adverse effect includes the disqualification of a plan or the disallowance of a deduction or credit for a contribution to a plan. The Internal Revenue Service, however, will not treat an old member as a member of an old group to the extent that such treatment will have an adverse effect on that old member.

(ii) Section 7805(b) will not be applied pursuant to paragraph (d)(2)(i) of this section to treat an old member of an old group as a member of a brother-sister controlled group to prevent an adverse effect for a taxable year if, for that taxable year, that old member treats or has treated itself as not being a member of that old group for purposes of section 401, 404(a), 408(k), 409A, 410, 411, 412, 414, 415, and 4971 of the Code and sections 202, 203, 204, and 302 and Title IV of ERISA for such taxable year (such as by filing, with respect to such taxable year, a return, amended return, or claim for credit or refund in which the amount of any deduction, credit, limitation, or tax due is determined by treating itself as not being a member of the old group for purposes of those sections). However, the fact that one or more (but not all) of the old members do not qualify for section 7805(b) treatment because of the preceding sentence will not preclude that old member (or members) from being treated as a member of the old group under paragraph (d)(2)(i) of this section in order to prevent the disallowance of a deduction or credit of another old member (or other corporation) or to prevent the disqualification of, or other adverse effect on, another old member's plan (or other entity) described in the sections of the Code and ERISA enumerated in such paragraph.

(3) *Election of general nonretroactivity.* In the case of a taxable year ending on or after December 31, 1970, and before (the date March 2, 1988), an old group will be treated as a brother-sister controlled group of corporations for all purposes of the Code for such taxable year if—

(i) Each old member files a statement consenting to such treatment for such taxable year with the District Director having audit jurisdiction over its return within six months after the date March 2, 1988 and

(ii) No old member (A) files or has filed, with respect to such taxable year, a return, amended return, or claim for credit or refund in which the amount of any deduction, credit, limitation, or tax due is determined by treating any old member as not a member of the old group or (B) treats the employees of all members of the old group as not being employed by a single employer for purposes of sections 401, 404(a), 408(k), 409A, 410, 411, 412, 414, 415, and 4971 of the Code and sections 202, 203, 204, and 302 of ERISA for such taxable year.

(4) *Definitions.* For purposes of this paragraph (d) of this section—

(i) An "old group" is a brother-sister controlled group of corporations, determined by applying paragraph (a)(3) of this section as in effect before the amendments made by Treasury decision 8179, (insert T.D. number of this), that is not a brother-sister controlled group of corporations, determined by applying paragraph (a)(3) of this section as amended by such Treasury decision, and

(ii) An "old member" is any corporation that is a member of an old group.

(5) *Election to choose between membership in more than one controlled group.* If—

(i) An old member has filed an election under paragraph (c)(2) of this section to be treated as a component member of an old group for a December 31 before March 2, 1988, and

(ii) That corporation would (without regard to such paragraph) be a component member of more than one brother-sister controlled group (not including an old group) on the December 31, that corporation may make an election under that paragraph by filing an amended return on or before September 2, 1988. This paragraph (d)(5) does not apply to a corporation that is treated as a member of an old group under paragraph (d)(3) of this section

(6) *Refunds.* See section 6511(a) for period of limitation on filing claims for credit or refund.

Par. 5. Section 1.1583-3 is amended by revising Example (3) in paragraph (d)(3) as set forth below.

§1.1563-3 Rules for determining stock ownership.

* * * * *

(d) *Special rule of section 1583(f)(3)(B)*

(3) *Examples.* * * *

Example (3). Unrelated individuals A and E each own 49 percent of all the outstanding stock of corporation R, which in turn owns 70 percent of the only class of outstanding stock of corporation S. The remaining 30 percent of the stock of corporation S is owned by unrelated individual C. C also owns the remaining 2 percent of the stock of corporation R. Under the attribution rule of paragraph (b)(4) of this section A and B are each considered to own 34.9 percent of the stock of corporation S. Accordingly, since five or fewer persons own at least 80 percent of the stock of corporations R and S and also own more than 50 percent identically (A's and B's identical ownership each is 34.3 percent, C's identical ownership is 2 percent), on December 31, 1970, corporations R and S are treated as component members of the same brother-sister controlled group.

Par. 6. Section 1.7476-1 is amended by removing from paragraph (b)(2)(i) "§11.414(c)-3 of this chapter (Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974))" and adding instead "§1.414(c)-3)".

Part 11—TEMPORARY INCOME TAX REGULATIONS UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

Par. 7. The authority citation for Part 11 continues to read in part:

Authority: 26 U.S.C. 7805. * * *

Par. 8. Sections 11.414(c)-1 through 11.414(c)-5 are removed.

Part 13—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1969

Par. 9. The authority citation for Part 13 continues to read in part:

Authority: 26 U.S.C. 7805. * * *

Par. 10. Sections 13.16 and 13.16-1 are removed.

Part 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 11. The authority citation for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 12. Section 602.101(c) is amended by adding the following citations to the table in the appropriate places:

§1.52-1(h)	1545-0797
§1.414(c)-5(f)	1545-0797
§1.1563-1(d)	1545-0797

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved February 9, 1988.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on March 1, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 2, 1988, 53 F.R. 6603)

Section 414

26 CFR 1.414(q)-1T: Highly compensated employee.

T.D. 8173

TITLE 26—INTERNAL REVENUE—CHAPTER I, SUBCHAPTER A—INCOME TAX—PART 1—INCOME TAX REGULATIONS

Definitions of Highly Compensated Employee and Compensation

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the scope and meaning of the terms "highly compensated employee" in section 414(q) and "compensation" in section 414(s) of the Internal Revenue Code of 1986. They reflect changes made by the Tax Reform Act of 1986 (TRA '86) and conform the regulations to sections 1114(a) and 1115 of the Tax Reform Act of 1986 (100 Stat. 2448 and 2453) [1986-3 C.B. (Vol. 1) 365, 369]. These regulations will provide the public with guidance necessary to comply with the law and would affect sponsors of, and participants in, pension, profit-sharing and stock bonus plans, and certain other employee benefit plans. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations for the notice of proposed rulemaking *** [page 880, this Bulletin].

DATE: In general, these regulations apply to years beginning on or after January 1, 1987, except as otherwise specified in TRA '86.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document amends the Income Tax Regulations (26 CFR Part 1) by adding new sections 1.414(q)-1T and 1.414(s)-1T to provide guidance with respect to the definitions of highly compensated employee and compensation within the meaning of Internal Revenue Code section 414(q) and (s).

AMENDMENTS TO QUALIFIED PLANS

Generally, subsections (q) and (s) of section 414 are definitional provisions that do not, of themselves, require plan amendments or impose operational requirements. However, in order to meet the requirements for qualification, plans are required to contain provisions designed to meet certain statutory requirements that rely on these definitions. Therefore, amendments will generally be necessary to conform plans to these definitions.

The definitions contained in subsections (q) and (s) of section 414 are generally effective for years beginning on or after January 1, 1987. Nevertheless, subject to certain conditions, a plan will not be disqualified solely because it is not amended to the extent necessary to conform to these definitions prior to the close of the amendment period contained in section 1140 of TRA '86. This delayed date for conforming amendments is conditioned on a requirement that such plan amendments are adopted retroactively to the later of the first day of the first plan year beginning after December 31, 1986, or the relevant effective date for the plan provisions to which these definitions are applicable. In addition, plans must satisfy the statutory requirements of applicable sections that incorporate these definitions in operation, beginning with the effective date for such requirements, notwithstanding the absence of plan provisions. For example, a plan to which the nondiscrimination tests of section 401(k)(3) or 401(m)(2) apply must satisfy these tests on the basis of comparisons between the group of highly compensated employees as defined in section 414(q) and the group of all other employees beginning with plan years beginning after December 31, 1986, except to the extent that the optional transition rule of §1.414(q)-1T Question and Answer (A) 15 is applicable. In contrast, the provisions of the coverage requirements of section 410(b), as amended by section 1112(a) of the TRA '86, which provisions contain tests based in part on groups of employees who are highly compensated employees within the meaning of section 414(q), are generally effective for plan years beginning after December 31, 1988.

AMENDMENT DATE FOR ELECTIVE PROVISIONS

These temporary regulations with respect to section 414(q) and (s) provide for certain elections that require corresponding plan provisions. Any amendments necessary to adopt such plan provisions may be made by the section 1140 delayed effective date in the same manner as amendments required with respect to TRA '86.

OPTIONAL TRANSITION RULE FOR 1987 AND 1988

A-15 of §1.414(q)-1T provides that certain employers with plans subject to the nondiscrimination requirements of section 401(k)(3) or plans that are subject to section 401(m)(2) may elect an optional transition rule in determining the group of "highly compensated employees" for purposes of applying these requirements to plan years beginning in 1987 or 1988. This elective rule is applicable solely to the transition period ending before the first plan year beginning on or after January 1, 1989. Thus, this elective rule may be used for the 1987 and 1988 determination year calculations and the corresponding 1986 and 1987 look-back year calculations for the 1987 and 1988 determination years. It may not, however, be used for the 1989 determination year calculation or the 1988 look-back year calculation with respect to the 1989 determination year. This rule is designed to reduce the potential administrative difficulties employers might experience in attempting to reconstruct data and initiate new compensation reporting systems for the transition period.

DEFINITION OF HIGHLY COMPENSATED EMPLOYEES

These temporary regulations under section 414(q) provide rules for determining which employees are "highly compensated employees". This term is used in various Code sections relating to qualified retirement plans, qualified cash or deferred arrangements, and certain other employee benefit plans for the purpose of determining whether these plans discriminate in favor of such employees. The term is also used in Code provisions that impose specific tax consequences on highly compensated employees. *See e.g.*, sections 402(b)(2) and 89(a)(1). This definition is generally applicable only to sections that incorporate the new definition of highly compensated employees by reference.

This regulation provides for two categories of highly compensated employees: highly compensated active employees and highly compensated former employees. The determination of whether such employees are active or former employees is made on the basis of whether or not the individual performed services for the employer during the determination year. Generally, the group of highly compensated active employees consists of individual who, at any time during the determination year, or the preceding year, were either: 5-percent owners of the employer; compensated by the employer in an amount above $75,000; compensated by the employer in an amount above $50,000 and within the top 20 percent of employees ranked by compensation paid by the employer; or officers of the employer whose compensation is above a certain level. The definition of highly compensated employees set forth in A-2(b) of these regulations anticipates that a technical correction indexing the threshold $75,000 and $50,000 dollar amounts at the same time and in the same manner as the section 415(b)(1)(A) dollar limitation for defined benefit plans will be enacted, with retroactive effect. Applying this rule, the indexed threshold dollar amounts for 1988 are $78,353 and $52,235 respectively. An elective special rule is provided for purposes of administrative simplicity in determining whether employees who left employment prior to the effective date of section 414(q) are highly compensated former employees. The regulations state that highly compensated active and former employees are to be identified on an employer-wide basis, taking into account the aggregation rules of section 414(b), (c), (m), and (o) and the rules with respect to leased and other deemed employees contained in section 414(n) and (o). The regulations further provide that the threshold dollar amounts used in determining who is a highly compensated employee are indexed to reflect changes in the cost of living at the same time and in the same manner as the section 415(b)(1)(A) limitation with respect to defined benefit plans.

Special rules are provided in the regulations for making determinations with respect to (1) which employees are officers and includible as highly compensated employees; (2) the manner in which the determination of highly compensated employees is made for the current year; (3) former employees; and (4) family aggregation.

The regulations do not include rules applicable to the identification of the highly compensated employees when there are changes in the composition of the employer due to mergers, acquisitions, divisive reorganizations, and similar business transactions. The Internal Revenue Service requests comments and suggestions with respect to the application of section 414(q) and these regulations to such situations. The Service plans to issue proposed rules on such situations later this year.

The regulations provide, where appropriate, that the definitions provided herein apply only to the definition of highly compensated employee in section 414(q) and these regulations. In addition, the specific rules with respect to family aggregation and the inclusion or exclusion of certain categories of employees (e.g. former employees and employees covered under a collective bargaining agreement) apply only to the extent not otherwise provided in regulations prescribed under sections that incorporate the definition of highly compensated employees.

RELATIONSHIP TO TITLE I OF ERISA

The primary purpose of section 414(q) of the Internal Revenue Code is to provide objective rules for identifying those employees of an employer who are to be treated as highly compensated employees in determining whether an employer-maintained retirement or other employee benefit plan impermissibly discriminates in favor of highly compensated employees. Nondiscrimination is a condition to many of the tax advantages provided with respect to such plans.

Some have inquired about whether section 414(q) is applicable with respect to the determination under sections 201(2), 301(a)(3), and 401(a)(1) of ERISA when an employee benefit plan is "maintained by an employer primarily for the purposes of providing deferred compensation for a select group of management or highly compensated employees." The Department of Labor has jurisdiction over the interpretation of these provisions. However, the Department of the Treasury would like to clarify its understanding that section 414(q) is not determinative with respect to provisions of Title I or ERISA, other than those provisions that explicitly incorporate such section by reference (e.g., section 408(b)(1)(B) of ERISA). The Departments of Treasury and Labor concur in the view that a braod extension of section 414(q) to determinations under sections 201(2), 301(a)(3), and 401(a)(1) of ERISA would be inconsistent with the tax and retirement policy objectives of encouraging employers to maintain tax-qualified plans that provide meaningful benefits to rank-and-file employees.

DEFINITION OF COMPENSATION

Generally, the term "compensation" as defined in section 414(s) means compensation, other than qualified or previously qualified deferred compensation, received for services performed for the employer that is currently includible in gross income for income tax purposes. This definition is generally applicable for Part 1 of Subchapter D of the Code, sections 401 through 419A, for purposes of applying the nondiscrimination rules (including the actual deferral percentage limits for cash or deferred arrangements and for employee and employer matching contributions). This section 414(s) definition of compensation is not applicable to sections that provide for another definition of compensation. For example, provisions to which this definition is not applicable include section 414(q) and section 415 for purposes of applying the section 415 limits on contributions and benefits except to the extent applicable to the section 415(c)(6) special rule with respect to employee stock ownership plans. A definition of compensation with respect to self-employed individuals is provided in A-2. These regulations also provide exceptions and alternatives to the section 414(s) definition of compensation in A-3 and A-4 of these regulations. Included among these alternatives is a provision permitting use of the section 415(c) definition of compensation. In this context, the Service contemplates revising the regulations with respect to section 415(c) and invites comment with respect to the section 415(c) definition of compensation as amended by TRA '86. The regulations also provide a delegation of authority to the Commissioner to provide for additional alternative definitions of compensation for purposes of section 414(s). It is anticipated that this delegation to the Commissioner will be exercised in the form of revenue rulings, Internal Revenue Bulletin notices or other Internal Revenue Service publications of general applicability.

EFFECTIVE DATE OF THESE REGULATIONS

These regulations are generally effective for plan years beginning on or after January 1, 1987, except as otherwise specified in TRA '86.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

* * * * *

Adoption of amendments to the regulations

Accordingly 26 CFR Part 1 is amended as follows:

INCOME TAX REGULATIONS

(26 CFR Part 1)

Paragraph 1. The authority citation for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. *** section 1.414(s)-1T is also issued under 26 U.S.C. 414(s).

Par. 2. There are inserted immediately after §1.414(l)-1 the following new sections 1.414(q)-1T and 1.414(s)-1T to read as follows:

§1.414(q)-1T Highly compensated employee (Temporary).

The following questions and answers relate to the definition of "highly compensated employee" provided in section 414(q). The definitions and rules provided in these questions and answers are provided solely for purposes of determining the group of highly compensated employees.

Table of contents.

Q&A-1 General applicability of section 414(q).
Q&A-2 Definition of highly compensated employees.
Q&A-3 Definition of highly compensated active employees.
Q&A-4 Definition of highly compensated former employees.
Q&A-5 Definition of separation year.
Q&A-6 Definition of employer.
Q&A-7 Definition of employee.
Q&A-8 Definition of 5-percent owner.
Q&A-9 Definition of top-paid group.
Q&A-10 Definition of officer and rules of inclusion of officers in highly compensated group.
Q&A-11 Rules with respect to family aggregation.
Q&A-12 Definition of family member.
Q&A-13 Definition of compensation.
Q&A-14 Rules with respect to the relevant determination periods.
Q&A-15 Transition rule applicable to plan years beginning in 1987 and 1988 for certain employers that have plans that must comply with the provisions of section 401(k)(3) or 401(m)(2).

Q-1: To what employee benefit plans and statutory provisions is the definition of highly compensated employee contained in section 414(q) applicable?

A-1: (a) *In general.* This definition is applicable to statutory provisions that incorporate the definition by reference.

(b) *Qualified retirement plans*—(1) *In general.* Generally, this definition is incorporated in many of the nondiscrimination requirements applicable to pension, profit-sharing, and stock bonus plans qualified under section 401(a). *See, e.g.*, the nondiscrimination provisions of sections 401(a)(4) and (5), 401(k)(3), 401(l), 401(m), 406(b), 407(b), 408(k), 410(b) and 411(d)(1). The definition is also incorporated by certain other provisions with respect to such plans, including the aggregation rules of section 414(m) and section 4975 (tax on prohibited transactions).

(2) *Not applicable where not incorporated by reference.* This definition is not applicable to qualified plan provisions that do not incorporate it. *See e.g.*, section 415 (limitations on contributions and benefits), with the exception of section 415(c)(3)(C) and 415(c)(6) (special rules for permanent and total disability and employee stock ownership plans respectively).

(c) *Other employee benefit plans or arrangements.* This definition is incorporated by various sections relating to employee benefit provisions. *See e.g.*, section 89 (certain other employee benefit plans), section 106 (accident and health plans), 117(d) (qualified tuition reduction), section 125 (cafeteria plans), section 129 (dependent care assistance programs), section 132 (certain fringe benefits), section 274 (certain entertainment, etc. expenses), section 423(b) (employee stock purchase plan provisions), section 501(c)(17) and (18) (certain exempt trusts providing benefits to employees), and section 505 (certain exempt organizations or trusts providing benefits to individuals). See the respective sections for the applicable effective dates.

(d) *ERISA*. This definition is not determinative with respect to any provisions of Title I of the Employee Retirement Income Security Act of 1974 (ERISA), unless it is explicitly incorporated by reference (e.g., section 408(b)(1)(B)).

Q-2: Who is a highly compensated employee?

A-2: The group of employees (including former employees) who are highly compensated employees consists of both highly compensated active employees (see A-3 of this §1.414(q)-1T) and highly compensated former employees (see A-4 of this §1.414(q)-1T). In many circumstances, highly compensated active employees and highly compensated former employees are considered separately in applying the provisions for which the definition of highly compensated employees in section 414(q) is applicable. Specific rules with respect to the treatment of highly compensated active employees and highly compensated former employees will be provided in the regulations with respect to the sections to which the definition of highly compensated employees is applicable.

Q-3: Who is a highly compensated active employee?

A-3: (a) *General rule.* For purposes of the year for which the determination is being made (the determination year), a highly compensated active employee is any employee who, with respect to the employer, performs services during the determination year and is described in any one or more of the following groups applicable with respect to the look-back year calculation and/or determination year calculation for such determination year. See A-14 for rules relating to the periods for which the look-back year calculation and determination year calculation are to be made.

(1) *Look-back year calculation.*

(i) *5-percent owner.* The employee is a 5-percent owner at any time during the look-back year (i.e., generally, the 12-month period immediately preceding the determination year; see A-14. (See A-8 of this §1.414(q)-1T.)

(ii) *Compensation above $75,000.* The employee receives compensation in excess of $75,000 during the look-back year.

(iii) *Compensation above $50,000 and top-paid group.* The employee receives compensation in excess of $50,000 during the look-back year and is a member of the top-paid group for the look-back year. (See A-9 of this §1.414(q)-1T.)

(iv) The employee is an "includible officer" during the look-back year. (See A-10 of this §1.414(q)-1T.)

(2) *Determination year calculation.*

(i) *5-percent owner.* The employee is a 5-percent owner at any time during the determination year. (See A-8 of this §1.414(q)-1T.)

(ii) *Top-100 employees.* The employee is both (A) described in paragraph (a)(1)(i), (ii) and/or (iv) of this A-3, when such paragraphs are modified to substitute the determination year for the look-back year, and (B) one of the 100 employees who receive the most compensation from the employer during the determination year.

(b) *Rounding and tie-breaking rules.* In making the look-back year and determination year calculations for a determination year, it may be necessary for an employer to adopt a rule for rounding calculations (e.g., in determining the number of employees in the top-paid group). In addition, it may be necessary to adopt a rule breaking ties among two or more employees (e.g., in identifying those particular employees who are in the top-paid group or who are among the 100 most highly compensated employees). In such cases, the employer may adopt any rounding or tie-breaking rules it desires, so long as such rules are reasonable, nondiscriminatory, and uniformly and consistently applied.

(c) *Adjustments to dollar threshold—*(1) *Indexing of dollar thresholds.* The dollar amounts in paragraph (a)(1)(i) and (ii) of this A-3 are indexed at the same time and in the same manner as the section 415(b)(1)(A) dollar limitation for defined benefit plans.

(2) *Applicable dollar threshold.* The applicable dollar amount for a particular determination year or look-back year is the dollar amount for the calendar year in which such determination year or look-back year begins. Thus, the dollar amount for purposes of determining the highly compensated active employees for a particular look-back year is based on the calendar year in which such look-back year begins, not the calendar year in which such look-back year ends or in which the determination year with respect to such look-back year begins.

(d) *Employees described in more than one group.* An individual who is a highly compensated active employee for a determination year, by reason of being described in one group in paragraph (a) of this A-3, under either the look-back year calculation or the determination year calculation, is not disregarded in determining whether another individual is a highly compensated active employee by reason of being described in another group under paragraph (a). For example, an individual who is a highly compensated active employee for a determination year, by reason of being a 5-percent owner during such year, who receives compensation in excess of $50,000 during both the look-back year and the determination year, is taken into account in determining the group of employees who are highly compensated active employees for such determination year by reason of (i) receiving more than $50,000, and (ii) being in the top-paid group under either or both the look-back year calculation or determination year calculation for such determination year.

(e) *Examples.* The following examples, in which the determination year and look-back year are the calendar year, are illustrative of the rules in paragraph (a) of this A-3. For purposes of these examples, the threshold dollar amounts in paragraph (a)(1)(ii) and (iii) of this A-3 are not increased pursuant to paragraph (c) of this A-3.

Example (1). Employee A, who is not at any time a 5-percent owner, an officer, or a member of the top-100 within the meaning of paragraph (a)(1)(i), or (iv), or (a)(2)(i) or (ii), but who was a member of the top-paid group for each year, is included in or excluded from the highly compensated group as specified below for the following years:

Year	*Compensation*	*Status*	*Comments*
1986	$45,000	N/A	Although prior to 414(q) effective date, 1986 constitute the look-back year for purposes of determining the highly compensated group for the 1987 determination year.
1987	$80,000	Excl.	Excluded because A was not an employee described in paragraph (a)(1)(ii) or (iii) of this A-3 for the look-back year (1986).
1988	$80,000	Incl.	Included because A was an employee described in paragraph (a)(1)(ii) or (iii) of this A-3 for the look-back year (1987).
1989	$45,000	Incl.	Included because A was an employee described in paragraph (a)(1)(ii) or (iii) of this A-3 for the look-back year (1988).
1990	$45,000	Excl.	Excluded because A was not an employee described in paragraph (a)(1)(ii) or (iii) of this A-3 for the look-back year (1989).

Example (2). Assuming the same facts as those given in *Example (1)*, except that A is a member of the top-100 employees within the meaning of paragraph (a)(2)(ii) of this A-3 for the 1987 year and 1990 year, the results are as follows:

Year	*Compensation*	*Status*	*Comments*
1986	$45,000	N/A	Although prior to 414(q) effective date, 1986 constitute the look-back year for purposes of determining the highly compensated group for the 1987 determination year.
1987	$80,000	Incl.	Included because A was an employee described in paragraph (a)(1)(ii) or (iii) of this A-3 for the determination year (1987) and was described in paragraph (a)(2)(ii) of this A-3 in that year.
1988	$80,000	Incl.	Included because A was an employee described in paragraph (a)(1)(ii) or (iii) of this A-3 for the look-back year (1987).
1989	$45,000	Incl.	Included because A was an employee described in paragraph (a)(1)(ii) or (iii) of this A-3 for the look-back year (1988).
1990	$45,000	Excl.	Excluded even though in top-100 employees during 1990 determination year because A was not an employee described in paragraph (a)(1)(ii) or (iii) of this A-3 for the look-back year (1989) or for the determination year (1990).

Q-4 Who is a highly compensated former employee?

A-4 (a) *General rule.* Except to the extent provided in paragraph (d) of this A-4, a highly compensated former employee for a determination year is any former employee who, with respect to the employer, had a separation year (as defined in A-5 of this §1.414(q)-1T) prior to the determination year and was a highly compensated active employee as defined in A-3 of this §1.414(q)-1T for either (1) such employee's separation year or (2) any determination year ending on or after the employee's 55th birthday. Thus, for example, an employee who is a highly compensated active employee for such employee's separation year, by reason of receiving over $75,000 during the look-back year, is a highly compensated former employee for determination years after such employee's separation year.

(b) *Special rule for employees who perform no services for the employer in the determination year.* For purposes of this rule, employees who perform no services for an employer during a determination year are treated as former employees. Thus, for example, an employee who performed no services for the employer during a determination year, by reason of a leave of absence during such year, is treated as a former employee for such year.

(c) *Dollar amounts for pre-1987 determination years.* For determination years beginning before January 1, 1987, the dollar amounts in paragraph (a)(1)(B) and (C) of A-2 of this §1.414(q)-1T are $75,000 and $50,000 respectively.

(d) *Special rule for employees who separated from service before January 1, 1987*—(1) *Election of special rule.* Employers may elect to apply paragraph (d)(2) of this A-4 in lieu of paragraph (a) of this A-4 in determining whether former employees who separated from service prior to January 1, 1987, are highly compensated former employees. If this election is made with respect to any qualified plan, it must be provided for in the plan. If the employer makes this election with respect to any employee benefit plan, such election must be used uniformly for all purposes for which the section 414(q) definition is applicable. The election, once made, cannot be changed without the consent of the Commissioner.

(2) *Special definition of highly compensated former employee.* A highly compensated former employee includes any former employee who separated from service with the employer prior to January 1, 1987, and was described in any one or more of the following groups during either (A) the employee's separation year (or the year preceding such separation year) or (B) any year ending on or after such individual's 55th birthday (or the last year ending before such employee's 55th birthday):

(A) *5-percent owner.* The employee was a 5-percent owner of the employer at any time during the year.

(B) *Compensation amount.* The employee received compensation in excess of $50,000 during the year.

The determinations provided for in this paragraph (b)(2) may be made on the basis of the calendar year, the plan year, or any other twelve month period selected by the employer and applied on a reasonable and consistent basis.

(e) *Rules with respect to former employees*—(1) *In general.* For specific provisions with respect to the treatment of former employees and of highly compensated former employees, refer to the rules with respect to which the section 414(q) definition of highly compensated employee is applicable.

(2) *Former employees excluded in determining top-paid group, top-100 employees and includible officers.* Former employees are not included in the top-paid group, the group of the top-100 employees, or the group of includible officers for purposes of applying section 414(q) to active employees. In addition, former employees are not counted as employees for purposes of determining the number of employees in the top-paid group.

Q-5 What is a separation year for purposes of section 414(q)?

A-5 (a) *Separation year*—(1) *In general.* The separation year generally is the determination year during which the employee separates from service with the employer. For purposes of this rule, an employee who performs no services for the employer during a determination year will be treated as having separated from service with the employer in the year in which such employee last performed services for the employer. Thus, for example, an employee who performs no services for the employer by reason of being on a leave of absence throughout the determination year is considered to have separated from service with the employer in the year in which such employee last performed services prior to beginning the leave of absence.

(2) *Deemed separation.* An employee who performs services for the employer during a determination year may be deemed to have separated from service with the employer during

such year pursuant to the rules in paragraph (a)(3) of this A-5. Such deemed separation year is relevant for purposes of determining whether such employee is a highly compensated former employee after such employee actually separates from service, not for purposes of identifying such employee as either an active or former employee. Because employees to whom the provisions of paragraph (a)(2) of this A-5 apply are still performing services for the employer during the determination year, they are treated provisions of paragraph (a) of this A-5 will not be treated as a highly compensated former employee (by reason of such deemed separation year) after such employee actually separates from service with the employer if, after such deemed separation year, and before the year of actual separation, such employee's services for and compensation from the employer for a determination year increase significantly so that such employee is treated as having a deemed resumption of employment. The determination of whether an employee who has incurred a deemed separation year has an increase in services and compensation sufficient to result in a deemed resumption of employment will be made on the basis of all the surrounding facts and circumstances pertaining to each individual case. At a minimum, there must be an increase in compensation from the employer to the extent that such compensation would not result in a deemed separation year under the tests in paragraph (a)(2)(i) and (ii) of this A-5 using the same three year period taken into account in such paragraph.

(c) *Examples.* Paragraphs (a) and (b) of this A-5 are illustrated by the following examples based on calendar years. For purposes of these examples the threshold dollar amounts in A-5(a) of this §1.414(q)-1T have not been increased pursuant to A-5(b) of this §1.414(q)-1T.

Example (1). Assume that in 1990 A is a highly compensated employee of X by reason of having earned more than $75,000 during the 1989 look-back year. In 1987, 1988 and 1989, A's years of greatest compensation received from X, A received $76,000, $80,000 and $79,000 respectively. In February of 1990, A received $30,000 in compensation. Because A's compensation during the 1990 determination year is less than 50% of A's average annual compensation from X during A's high three prior determination years, A is deemed to have a separation year during the 1990 determination year pursuant to the provisions of paragraph (a) of this A-5. Since A is a highly compensated employee for X in 1990, A's deemed separation year, A will be treated as a highly compensated former employee after A actually separates from service with the employer unless A experiences a deemed resumption of employment within the meaning of paragraph (b) of this A-5.

Example (2). Assume that in 1990 A is a highly compensated employee by reason of having been an officer (with annual compensation in excess of the section 415(c)(1)(A) dollar limitation) during the 1989 look-back year. A's compensation from X during 1990 is $37,000. A's average compensation from X for the three-year period ending with or within January, 1990, was $60,000. A's compensation during the 1990 determination year is not less than 50% of the compensation earned during the test period. Therefore, A is not deemed to have a separation year under paragraph (a)(2)(i) of this A-5.

Example (3). Assume that in 1990 C is 35 and a highly compensated employee of Z for the reasons given in *Example (1)* with the same compensation set forth in that example. During 1990, D leaves C's 40 hour a week position as director of the actuarial division of Z and starts working as an actuary for the same division, producing actuarial reports approximately 15 to 20 hours a week, approximately half of these hours at home. C contemplates returning to full-time employment with Z when C's child enters school. During the 1990 determination year, C's compensation is less than 50% of C's compensation during her high three preceding determination years. Therefore, C has a deemed separation year during the 1990 determination year. In 1991 C commences working 32 hours a week for X at X's place of business and receives compensation in an amount equal to 80 percent of her average annual compensation during her high three prior determination years. The C's increased compensation, considered in conjunction with the reasons for the reduction in service, the nature and extent of the services performed before and after the reduction in services, and the lack of proximity of C's age to age 55 at the time of the reduction are sufficient to establish that C has a deemed resumption of employment within the meaning of paragraph (b) of this A-5. Therefore, when C separates from service with the employer, C will not be treated as a highly compensated former employee by reason of C's deemed separation year in 1990.

Q-6 Who is the employer?

A-6 (a) *Aggregation of certain entities.* The employer is the entity employing the employees and includes all other entities aggregated with such employing entity under the aggregation requirements of section 414(b), (c), (m) and (o). Thus, the following entities must be taken into account as a single employer for purposes of determining the employees who are "highly compensated employees" within the meaning of section 414(q):

(1) All corporations that are members of a controlled group of corporations (as defined in section 414(b)) that includes the employing entity.

(2) All trades or businesses (whether or not incorporated) that are under common control (as defined in section 414(c)) which group includes the employing entity.

(3) All organizations (whether or not incorporated) that are members of an affiliated service group (as defined in section 414(m)) that includes the employing entity.

(4) Any other entities required to be aggregated with the employing entity pursuant to section 414(o) and the regulations thereunder.

(b) *Priority of aggregation provisions.* The aggregation requirements of paragraph (a) of this A-6 and of A-7(b) of this section with respect to leased employees are applied before the application of any of the other provisions of section 414(q) and this section.

(c) *Line of business rules.* The section 414(r) rules with respect to separate lines of business are not applicable in determining the group of highly compensated employees.

Q-7: Who is an employee for purposes of section 414(q)?

A-7: (a) *General rule.* Except as provided in paragraph (b) of this A-7, the term "employee" for purposes of section 414(q) refers to individuals who perform services for the employer and are either common-law employees of the employer or self-employed individuals who are treated as employees pursuant to section 401(c)(1). This rule with respect to the inclusion of certain self-employed individuals in the group of highly compensated employees is applicable whether or not such individuals are eligible to participate in the plan or benefit arrangement being tested.

(b) *Leased employees*—(1) *In general.* The term "employee" includes a leased employee who is treated as an employee of the recipient pursuant to the provisions of section 414(n)(2) or 414(o)(2). Employees that an employer treats as leased employees under section 414(n), pursuant to the requirements of section 414(o), are considered to be leased employees for purposes of this rule.

(2) *Safe-harbor exception.* For purposes of qualified retirement plans, if

an employee who would be a leased employee within the meaning of section 414(n)(2) is (i) covered in a safe-harbor plan described in section 414(n)(5) (a qualified money purchase pension plan maintained by the leasing organization), and (ii) not otherwise covered under a qualified retirement plan of the employer, then such employee is excluded from the term "employee" unless the employer elects to include such employee pursuant to the provisions of subparagraph (4) of this paragraph (b).

(3) *Other employee benefit plans.* The exception in paragraph (b)(2) of this A-7 is not applicable to the determination of the highly compensated employee group for purposes of the sections enumerated in section 414(n)(3)(C). Thus, for example, a leased employee covered by a safe-harbor plan is considered to be an employee in applying the nondiscrimination provisions of section 89 to statutory benefit plans. Consequently, an employer with leased employees covered in a safe-harbor plan may have 2 groups of highly compensated employees, one with respect to its retirement plans and another with respect to its statutory benefit plans.

(4) *Election with respect to leased employee exclusion.* An employer may elect to include the employees excepted under the provisions of paragraph (b)(2) of this A-7 in determining the highly compensation group with respect to an employer's retirement plans. Thus, for example, by electing to forego the exception in paragraph (b)(2) of this A-7, an employer may achieve more uniform highly compensated employee groups for purposes of its retirement plans and welfare benefit plans. The election to include such employees must be made on a reasonable and consistent basis and must be provided for in the plan.

Q-8: Who is a 5-percent owner of the employer?

A-8: An employee is a 5-percent owner of the employer for a particular year if, at any time during such year, such employee is a 5-percent owner as defined in section 416(i)(B)(i) and §1.416-1 A T-17&18. Thus, if the employer is a corporation, a 5-percent owner is any employee who owns (or is considered as owning within the meaning of section 318) more than 5 percent of the value of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a 5-percent owner is any employee who owns more than 5 percent of the capital or profits interest in the employer. The rules of subsections (b), (c), and (m) of section 414 do not apply for purposes of determining who is a 5-percent owner. Thus, for example, an individual who is a 5-percent owner of a subsidiary corporation that is part of a controlled group of corporations within the meaning of section 414(b) is treated as a 5-percent owner for purposes of these rules.

Q-9: How is the "top-paid group" determined?

A-9: (a) *General rule.* An employee is in the top-paid group of employees for a particular year if such employee is in the group consisting of the top 20 percent of the employer's employees when ranked on the basis of compensation received from the employer during such year. The identification of the particular employees who are in the top-paid group for a year involves a two-step procedure: (1) the determination of the number of employees that corresponds to 20 percent of the employer's employees, and (2) the identification of the particular employees who are among the number of employees who receive the most compensation during the year. Employees who perform no services for the employer during a year are not included in making either of these determinations for such year.

(b) *Number of employees in the top-paid group*—(1) *Exclusions.* The number of employees who are in the top-paid group for a year is equal to 20 percent of the total number of active employees of the employer for such year. However, solely for purposes of determining the total number of active employees in for a year, the employees excluded in subdivisions (i), (ii), and (iii) of this paragraph (b)(1) are disregarded.

(i) *Age and service exclusion.* The following employees are excluded on the basis of age or service absent an election by the employer pursuant to the rules in paragraph (b)(2) of this A-9:

(A) Employees who have not completed 6 months of service by the end of such year. For purposes of this subdivision (A), an employee's service in the immediately preceding year is added to service in the current year in determining whether the exclusion is applicable with respect to a particular employee in the current year. For example, given a plan with a calendar determination year, if employee A commences work August 1, 1989, and terminates employment May 31, 1990, A may be excluded under this paragraph (b)(1)(i)(A) in 1989 because A completed only 5 months of service by December 31, 1989. However, A cannot be excluded pursuant to this rule in 1990 because A has completed 10 months of service, for purposes of this rule, by the end of 1990.

(B) Employees who normally work less than 17 1/2 hours per week as defined in paragraph (d) of this A-9 for such year.

(C) Employees who normally work during less than 6 months during any year as defined in paragraph (e) of this A-9 for such year.

(D) Employees who have not had their 21st birthdays by the end of such year.

(ii) *Nonresident alien exclusion.* Employees who are nonresident aliens and who receive no earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3)) are excluded.

(iii) *Collective bargaining exclusion*—(A) *In general.* Except as provided in subdivision (B) of this paragraph (b)(1)(iii), employees who are included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and the employer, which agreement satisfies section 7701(a)(46) and §301.7701-17T (Temporary), are included in determining the number of employees in the top-paid group.

(B) *Percentage exclusion provision.* If (1) 90 percent or more of the employees of the employer are covered under collective bargaining agreements that the Secretary of Labor finds to be collective bargaining agreements between employee representatives and the employer, which agreements satisfy section 7701(a)(46) and §301.7701-17T (Temporary), and (2) the plan being tested covers only employees who are not covered under such agreements, then the employees who are covered under such collective bargaining agreements are not counted in determining the number of noncollective bargaining employees who will be included in the top-paid group for purposes of testing such plan. In addition, such employees are not included in the top-paid group for such purposes. Thus, if the conditions of this paragraph (b)(1)(iii)(B) are satisfied, a separate calculation is required to determine the number and identity of noncollective bargaining employees who will be highly compensated employees by reason of receiving over $50,000 and being in the top-paid group of employees for purposes of testing those plans that cover only noncollective bargaining employees.

(2) *Alternative exclusion provisions*—(i) *Age and service exclusion election.* An employer may elect, on a consistent and uniform basis, to modify the permissible exclusions set forth in paragraph (b)(1)(i)(A), (B), (C), and (D) of this A-9 by substituting any shorter period of service or lower age than that specified in such paragraph. These exclusions may be modified to substitute a zero service or age requirement.

(ii) *Election not to apply percentage exclusion provision.* An employer may elect not to exclude employees under the rules in paragraph (b)(1)(iii)(B) of this A-9.

(iii) *Method of election.* The elections in this paragraph (b)(2) must be provided for in all plans of the employer and must be uniform and consistent with respect to all situations in which the section 414(q) definition is applicable to the employer. Thus, with respect to all plan years beginning in the same calendar year, the employer must apply the test uniformly for purposes of determining its top-paid group with respect to all its qualified plans and employee benefit plans and for purposes of the line of business rules set forth in section 414(r). If either election is changed during the determination year, no recalculation of the look-back year based on the new election is required, provided the change in election does not result in discrimination in operation.

(c) *Identification of top-paid group members.* With the exception of the paragraph (b)(1)(iii) of this A-9 exclusion for certain employees covered by collective bargaining agreements, the exclusions in paragraph (b)(1) of this A-9 are not applicable for purposes of identifying the particular employees in the top-paid group. Thus, for example, even if an employee who normally works for less than 17 1/2 hours is excluded in determining the number of employees in the top-paid group, such employee may be a member of the top-paid group. Similarly, if during a determination year, employee A receives over $75,000 and is one of the top-100 employees ranked by compensation, then employee A is a highly compensated active employee for such determination year. This is true even though employee A has worked less than six months and thus may be excluded in determining the number of persons in the top-paid group for the determination year.

(d) *Example.* Paragraphs (b) and (c) of this A-9 are illustrated by the following example:

Example. Employer X has 200 active employees during the 1989 determination year, 100 of whom normally work less than 17 1/2 hours per week during such year and 80 of whom normally work less than 15 hours per week during such year. X elects to exclude all employees who normally work less than 15 hours per week in determining the number of employees in the top-paid group. Thus, X excludes 80 employees in determining the number of employees in the top-paid group. X's top-paid group for the 1989 determination year consists of 20% of 120 or 24 employees. All 200 of X's employees must then be ranked in order by compensation received during the year, and the 24 employees X paid the greatest amount of compensation during the year are top-paid employees with respect to X for the 1989 determination year.

(e) *17 1/2 hour rule*—(1) *In general.* The determination of whether an employee normally works less than 17 1/2 hours per week is made independently for each year based on the rules in paragraph (e)(2) and (3) of this A-9. In making this determination, weeks during which the employee did not work for the employer are not considered. Thus, for example, if an employee normally works twenty hours a week for twenty-five weeks during the fall and winter school quarters, 10 hours a week for the 12 week spring quarter, and does not work for the employer during the three-month summer quarter, such employee is treated as normally working more than 17 1/2 hours per week under the rule of this paragraph (e).

(2) *Deemed above 17 1/2.* An employee who works 17 1/2 hours a week or more, for more than fifty percent of the total weeks worked by such employee during the year, is deemed to normally work more than 17 1/2 hours a week for purposes of this rule.

(3) *Deemed below 17 1/2.* An employee who works less than 17 1/2 hours a week for fifty percent or more of the total weeks worked by such employee during the year is deemed to normally work less than 17 1/2 hours a week for purposes of this rule.

(4) *Application.* The determination provided for in paragraph (e)(1), (2), and (3) of this A-9 may be made (i) separately with respect to each employee, or (ii) on the basis of groups of employees who fall within particular job categories as established by the employer on a reasonable basis. For example, under the rule of this paragraph (e)(4) an employer may exclude all office cleaning personnel if, for the year in question, the employees performing this function normally work less than 17 1/2 hours a week. This is true even though one or more employees within this group normally work in excess of 17 1/2 hours. The election to make this determination on the basis of individuals or groups is operational and does not require a plan provision.

(5) *Application based on groups.* (i) Groups of employees who perform the same job are not required to be considered as one category for purposes of the rule in paragraph (e)(4) of this A-9. Thus, for example, an employer supermarket may determine its highly compensated employees by excluding part-time grocery checkers if such personnel normally work less than 17 1/2 hours a week while continuing to include full-time personnel performing this function. In general, 80 percent of the positions within a particular job category must be filled by employees who normally work less than 17 1/2 hours a week before any employees may be excluded under this rule on the basis of their membership in that job category.

(ii) Alternatively, an employer may exclude employees who are members of a particular job category if the median number of hours of service credited to employees in that category during a determination or look-back year is 500 or less.

(f) *6-month rule*—(1) *In general.* The determination of whether employees normally work during not more than 6 months in any year is made on the basis of the facts and circumstances of the particular employer as evidenced by the employer's customary experience in the years preceding the determination year. An employee who works on one day during a month is deemed to have worked during that month.

(2) *Application of prior year experience.* In making the determination under this paragraph (f), the experience for years immediately preceding the determination year will generally be weighed more heavily than that of earlier years. However, this emphasis on more recent years is not appropriate if the data for a particular year reflects unusual circumstances. For example, if fishermen working for employer X worked 9 months in 1987 and 1988, 8 months in 1989, and then, because of abnormal ice conditions, worked only 5 months in 1990, such fishermen could not be excluded under this rule in 1990. Furthermore, the data with respect to 1990 would not be weighed more heavily in making a determination with respect to subsequent years.

(3) *Individual or group basis.* This determination may be made separately with respect to each employee or on the basis of groups of employees who fall within particular job categories in the manner set forth in paragraph (e)(4) of this A-8.

Q-10: For purposes of determining the group of highly compensated employees, which employees are officers and which officers must be included in the highly compensated group?

A-10: (a) *In general.* Subject to the limitations set forth in paragraph (b) of this A-10 and the top-100 employee rule set forth in A-2, an employee is an includible officer for purposes of this section and is a member of the group of highly compensated employees if such employee is (1) an officer of the employer (within the meaning of section 416(i) and §1.416-1A-T 13 & A-T 15) at any time during the determination year or look-back year and (2) receives compensation during such year that is greater than 150 percent of the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which the determination or look-back year begins. In addition, an officer who does not meet the 415(c)(1)(A) dollar limitation requirement may be an includible officer based on the minimum inclusion rules set forth in paragraph (c) of this A-10.

(b) *Maximum limitation*—(1) *In general.* No more than 50 employees (or, if lesser, the greater of 3 employees or 10 percent of the employees without regard to any exclusions) shall be treated as officers for purposes of this provision in determining the group of highly compensated employees for any determination year or look-back year.

(2) *Total number of employees.* The total number of employees for purposes of the limitation in this paragraph (b) is the number of employees the employer has during the particular determination year or look-back year. For purposes of this A-10, employees include only those individuals who perform services for the employer during the determination or look-back year. The exclusions applicable for purposes of determining the number of employees in the top-paid group are not applicable for purposes of the limitations in this paragraph (b).

(3) *Inclusion ranking.* If the number of the employer's officers who satisfy paragraph (a) of this A-10 during either the determination year or the look-back year exceeds the limitation under this paragraph (b), then the officers who will be considered as includible officers for purposes of this rule are those who receive the greatest compensation from the employer during such determination or look-back year. The definition of compensation in A-13 is to be used for this purpose.

(c) *Minimum inclusion rule.* This paragraph (c) is applicable when no officer of the employer satisfies the compensation requirements of paragraph (a) of this A-10 during either a determination year or look-back year. In such case, the highest paid officer of the employer for such year is treated as a highly compensated employee by reason of being an officer, without regard to the amount of compensation paid to such officer in relation to the section 415(c)(1)(A) dollar amount for the year. This is true whether or not such employee is also a highly compensated employee on any other basis. Thus, for example, if no officer of employer X meets the compensation requirements of paragraph (a) of this A-10 during the 1989 look-back year, and employee A is both the highest paid officer during such year and a 5-percent owner, employee A is treated as an includible officer satisfying the minimum inclusion rules of this paragraph.

(d) *Separate application.* The maximum and minimum officer inclusion rules of paragraphs (b) and (c) of this A-10 apply separately with respect to the determination year calculation and the look-back year calculation. Thus, for example, if no officer of employer X receives compensation above the threshold amount in paragraph (a) of this A-10 during either the determination year or look-back year, application of the minimum inclusion rule would result in the officer of employer X who received the greatest compensation during the look-back year being treated as a highly compensated employee and, in addition, the officer of employer X who receives the most compensation during the determination year would be included in the highly compensated group if such officer is also in the top-100 employees of employer X for such year. Thus, two officers may be treated as highly compensated active employees for a determination year by reason of the provisions of the minimum inclusion rule.

Q-11: To what extent must family members who are employed by the same employer be aggregated for purposes of section 414(q)?

A-11: (a) *Family aggregation*—(1) *In general.* Aggregation is required with respect to an employee who is, during a particular determination year or look-back year, a family member (as defined in A-12) of either (i) a 5-percent owner who is an active or former employee or (ii) a highly compensated employee who is one of the ten most highly compensated employees ranked on the basis of compensation paid by the employer during such year.

(2) *Aggregation of contributions or benefits.* As prescribed in regulations under the provisions to which section 414(q) is applicable, a family member and a 5-percent owner or top-10 highly compensated employee aggregated under this rule are generally treated as a single employee receiving an amount of compensation and a plan contribution or benefit that is based on the compensation, contributions, and benefits of such family member and 5-percent owner or top-10 highly compensated employee.

(b) *Exclusion status irrelevant.* Family members are subject to this aggregation rule whether or not they fall within the categories of employees that may be excluded for purposes of determining the number of employees in the top-paid group and whether or not they are highly compensated employees when considered separately.

(c) *Order of determination*—(1) *Determination of highly compensated employees.* The determination of which employees are highly compensated employees and which highly compensated employees are among the ten most highly compensated employees in making the look-back year calculation or the determination year calculation for a determination year will be made prior to the application of the rules in paragraph (a) of this A-11.

(2) *Determination of top-paid group and top-100 employees.* The determination of the number and identity of employees in the top-paid group under the look-back year calculation or the determination year calculation for a determination year and the identity of individuals in the top-100 employees under the determination year calculation for a determination year is made prior to application of the rules in paragraph (a) of this A-11.

(d) *Determination period.* The rules under paragraph (a) of this A-11 apply separately to the determination year and the look-back year. Thus, assuming there are no 5-percent owners, if employees, A, B, C, D, E, F, G, H, I and J are the top 10 highly compensated employees in the 1988 look-back year, and employees F, G, H, I J, K, L, M, N and O are the top 10 highly compensated employees in the 1989 determination year, then family aggregation would be required with respect to all fifteen of such employees (i.e., employees A, B, C, D, E, F, G, H, I, J, K, L, M, N, and O).

Q-12: Which individuals are family members for purposes of the aggregation rules in section 414(q)(6)(A) and A-11?

A-12: (a) *Definition of family member.* Individuals who are family members for purposes of these provisions include, with respect to any employee or former employee, such employee's or former employee's spouse and lineal ascendants or descendants and the spouses of such lineal ascendants and descendants. In determining whether an individual is a family member with respect to an employee or former employee, legal adoptions shall be taken into account.

(b) *Test period.* If an individual is a family member with respect to an employee or former employee on any day during the year, such individual is treated as a family member for the entire year. Thus, for example, if an individual is a family member with respect to an employee on the first day of a year, such individual continues to be a family member with respect to such employee throughout the year even though their relationships changes as a result of death or divorce.

Q-13: How is "compensation" determined for purposes of determining the group of "highly compensated employees."

A-13: (a) *In general.* For purposes of section 414(q), the term "compensation" means compensation within the meaning of section 415(c)(3) without regard to sections 125, 402(a)(8), and 402(h)(1)(B) and, in the case of employer contributions made pursuant to a salary reduction agreement, without regard to section 403(b). Thus, compensation includes elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement or tax-sheltered annuity.

(b) *Determination period.* For purposes of determining the group of highly compensated employees, compensation must be calculated on the basis of the applicable period for the determination year and look-back year respectively.

(c) *Compensation taken into account.* Only compensation received by an employee during the determination year or during the look-back year is considered in determining whether such employee is a highly compensated active employee under either the look-back year calculation or determination year calculation for such determination year. Thus, compensation is not annualized for purposes of determining an employee's compensation in the determination year or the look-back year in applying the rules of paragraph (a) of this A-13.

Q-14: What periods must be used for determining who is a highly compensated employee for a determination year?

A-14: (a) *Determination year and look-back year*—(1) *In general.* For purposes of determining the group of highly compensated employees for a determination year, the determination year calculation is made on the basis of the applicable year of the plan or other entity for which a determination is being made and the look-back year calculation is made on the basis of the twelve month period immediately preceding such year. Thus, in testing plans X and Y of an employer, if plan X has a calendar year plan year and plan Y has a July 1 to June 30 plan year, the determination year calculation and look-back year calculation for plan X must be made on the basis of the calendar year. Similarly, the determination year calculation and look-back year calculation for plan Y must be made on the basis of the July 1 to June 30 year.

(2) *Applicable year.* For purposes of this A-14, the applicable year is the plan year of the qualified plan or other employee benefit arrangement to which the definition of highly compensated employees is applicable as defined in the written plan document or otherwise identified in regulations pursuant to sections to which the definition of highly compensated employees is applicable. To the extent that the definition of highly compensated employees is applicable to entities or other arrangements that do not have an otherwise identified plan year, then either the calendar year or the employer's fiscal year may be treated as the plan year.

(3) *Look-back year.* The look-back year is never less than a twelve month period.

(b) *Calendar year calculation election*—(1) *In general.* An employer may elect to make the look-back year calculation for a determination year on the basis of the calendar year ending with or within the applicable determination year (or, in the case of a determination year that is shorter than twelve months, the calendar year ending with or within the twelve-month period ending with the end of the applicable determination year). In such case, the employer must make the determination year calculation for the determination year on the basis of the period (if any) by which the applicable determination year extends beyond such calendar year (i.e., the lag period). If the applicable year for which the determination is being made is the calendar year, the employer still may elect to make the calendar year calculation election under this A-14(b). In such case, the look-back year calculation is made on the basis of the calendar year determination year and, because there is no lag period, a separate determination year calculation under A-3(a)(2) of this §1.414(q)-1 is not required.

(2) *Lag period calculation.* In making the determination year calculation under A-3(a)(2) of this §1.414(q)-1 on the basis of the lag period, the dollar amounts applicable under A-3(a)(1)(B) and (C) of this §1.414 (q)-1 are to be adjusted by multiplying such dollar amounts by a fraction, the numerator of which is the number of calendar months that are included in the lag period and the denominator of which is twelve.

(3) *Determination of active employees.* An employee will be considered an active employee for purposes of a determination year for which the calendar year calculation election is in effect so long as such employee performs services for the employer during the applicable year for which the determination is being made. This is the case even if such employee does not perform services for the employer during the lag-period for such determination year.

(4) *Election requirement.* If the employer elects to make the calendar year calculation election with respect to one plan, entity, or arrangement, such election must apply with respect to all plans, entities, and arrangements of the employer. In addition, such election must be provided for in the plan.

(c) *Change in applicable years.* Where there is a change in the applicable year for which a determination is being made with respect to a plan entity, or other arrangement that is not subject to the calendar year calculation election, the look-back year calculation for the short applicable year is to be made on the basis of the twelve month period preceding the short applicable year (i.e., generally, the old applicable year) and the determination year calculation for the short applicable year is to be made on the basis of the short applicable year. In addition, the dollar amounts under A-3(a)(1)(B) and (C) are to be adjusted for such determination year calculation as if the short applicable year were a lag period under paragraph (b)(2) of this A-14.

(e) *Example.* The following examples illustrate the rules of this A-14:

Example 1. Employer X has a single plan (Plan A) with an April 1 to March 31 plan year. Employer X makes no election to use the calendar year for the determination period. Therefore, in determining the group of highly compensated employees for the April 1, 1989 to March 31, 1990 plan year, the determination year is the plan year ending March 31, 1990 and the look-back year is the plan year ending March 31, 1989.

Example 2. Assume the same facts given above. With respect to the plan year beginning in 1990, employer X elects to use the calendar year for the determination period. Therefore, in determining the group of highly compensated employees for the April 1, 1990 to March 31, 1991 plan year, the lag-period determination year is the period from January 1, 1991, through March 31, 1991, and the applicable look-back year is the 1990 calendar year.

Example 3. Employer Y has a single plan (Plan B) with a calendar plan year. With respect to the plan year beginning in 1990, employer Y elects to make the look-back year calculation for the 1990 determination year on the basis of the calendar year ending with or within the 1990 determination year. Because employer Y's determination year is the 1990 calendar year there is no lag period and employer Y determines the group of highly compensated employees for purposes of the 1990 calendar plan year on the basis of such plan year alone.

Q-15: Is there any transition rule in determining the group of highly compensated employees for 1987 and 1988?

A-15: (a) *In general.* Solely for purposes of section 401(k)(3) and (m)(2) and solely for twelve-month plan years beginning in 1987 and 1988, an eligible employer may elect to define the group of highly compensated employees as the group consisting of 5-percent owners of the employer at any time during the plan year and employees who receive compensation in excess of $50,000 during the plan year. This rule would apply in lieu of the look-back year calculation and determination year calculation otherwise applicable under A-3(a) of this §1.414(q)-1. In addition, an eligible employer may elect to make the determinations permitted under this transition rule on the basis of the calendar year ending in the plan year and the period by which such plan year extends beyond such calendar year, in accordance with the rules of A-14(b), in lieu of making the determinations under this transition rule on the basis of the plan year for which the determinations are being made.

(b) *Eligible employers.* An employer is an eligible employer under this A-15 if such employer satisfies both of the following requirements:

(1) The employer does not maintain any top-heavy plan within the meaning of section 416 at any time during 1987 and 1988; and

(2) Under each plan of the employer to which section 401(k)(3) or 401(m)(2) is applicable, the group of eligible employees that comprises the highest 25% of eligible employees ranked on the basis of compensation includes at least one employee whose compensation is $50,000 or below. This requirement must be met separately with respect to each such plan of the employer.

(c) *Uniformity requirement.* An eligible employer may not make the election under paragraph (a) of this A-15 unless the election applies to all of the plans maintained by the employer to which section 401(k)(3) or 401(m)(2) applies.

(d) *Election requirements.* This election is operational and does not require a plan provision.

§1.414(s)-1T Compensation.

The following questions and answers relate to the definition of compensation provided in section 414(s). The definitions and rules provided in these questions and answers are provided solely for purposes of defining "compensation" under this section.

TABLE OF CONTENTS

Q&A-1 General definition of compensation.

Q&A-2	Definition of compensation for self-employed individuals.
Q&A-3	Election with respect to certain deferred compensation.
Q&A-4	Alternative definitions of compensation.

Q-1: What is the basic definition of compensation for purposes of section 414(s) and when is this definition applicable?

A-1: (a) *In general.* For purposes of section 414(s), the term "compensation" means compensation received during the applicable period by the employee from the employer, other than compensation in the form of qualified or previously qualified deferred compensation, that (taking into account the provisions of this chapter) is currently includible in gross income for income tax purposes. *See* A-3 and A-4 of this §1.414(s)-1 for adjustments and alternatives to this basic definition.

(b) For purposes of this section, the "applicable period" is the period of time specified under the particular rule for which the section 414(s) definition of compensation is applicable. Thus, the regulations applicable to a particular rule that utilizes the section 414(s) definition of compensation will specify the applicable period under section 414(s) for purposes of such rule.

(c) *Applicability.* The definition in paragraph (a) of this A-1 is generally applicable for purposes of applying the nondiscrimination rules of sections 401 through 419A (including the actual deferral percentage test for a cash or deferred arrangement and the actual contribution percentage test for employee and employer matching contributions contained in section 401(k)(3) and 401(m)(3) respectively). However, the definition of compensation in paragraph (a) of this A-1 does not apply to sections that specifically define compensation in a different manner. Examples of provisions for which the section 414(s) definition of compensation is not applicable include, but are not limited to, the definition of highly compensated employees contained in section 414(q), the limitations on benefits and contributions set forth in section 415, and the deduction provisions of section 404(a) and (b).

Q-2: How is compensation determined for self-employed individuals within the meaning of section 401(c)(1)?

A-2: The basic definition of compensation, for purposes of self-employed individuals, is earned income (as defined in section 401(c)(1)) for the applicable period (as defined in A-1(c) of this §1.414(s)-1) derived from such individual's trade or business.

Q-3: May an employer elect to treat certain deferrals as compensation?

A-3: Yes. An employer may elect to include in the basic definition of compensation all elective contributions made by the employer on behalf of its employees that are not includible in the gross income of an employee under sections 125, 402(a)(8), 402(h), or 403(b). This election must be made on a consistent and uniform basis with respect to all employees and all plans of the employer for any particular year, must be made on a reasonable and consistent basis from year to year, and must be provided for in the plan. The employer may change this election provided such change does not result in discrimination in favor of highly compensated employees.

Q-4: What, if any, alternative definitions of compensation may be used by an employer?

A-4: (a) *Alternative basic definitions.* For applicable periods beginning in 1987 and 1988, an employer may elect to use the following alternative definitions of compensation in lieu of the basic definition set forth in A-1 of this section. Any such election must be provided for in the plan and made on a reasonable and consistent basis from year to year. An employer may change an election made under this A-4(a) provided such change does not result in discrimination in favor of highly compensated employees.

(1) *W-2 compensation.* Compensation received during the applicable period (as defined in A-1(c) of this §1.414(s)-1) by the employee from the employer that is required to be reported as wages on the employee's Form W-2 for income tax purposes. This election may include or exclude all amounts that are not currently includible in the employee's gross income by reason of the application of sections 125, 402(a)(8), 402(h)(1)(B) or 402(b), provided such total inclusion or exclusion is (i) made on a consistent and uniform basis with respect to all plans of the employer for any particular year, (ii) made on a reasonable and consistent basis from year to year, and (iii) provided for in the plan. The employer may change this inclusion or exclusion election provided such change does not result in discrimination in favor of highly compensated employees.

(2) *Section 415 compensation.* Compensation as defined in §1.415-2(d)(1)&(2) received during the applicable period (as defined in A-1(c) of this §1.414(s)-1) by the employee from the employer.

(b) *Alternative definitions*—(1) *In general.* In lieu of the basic definition of compensation set forth in A-1 of this §1.414(s)-1 (and in lieu of the alternative basic definitions set forth in (a) of this A-4), an employer may elect to use an alternative definition of compensation. Any such alternative definition is permissible under section 414(s) only if it is described in A-4(b)(2) and satisfies the nondiscrimination rule set forth in A-4(b)(3).

(2) *Available alternative definitions of compensation*—(i) *Regular or base salary or wages.* Regular or base salary or wages (excluding overtime and bonuses) received during the applicable period (defined in A-1(c) of this §1.414(s)-1) by the employee from the employer.

(ii) *Regular or base salary or wages plus overtime and/or bonuses.* Regular or base salary or wages, plus either or both overtime and/or bonuses, received during the applicable period (defined in A-1(c) of this §1.414(s)-1) by the employee from the employer.

(iii) *Commissioner may make additional definitions available.* The Commissioner may, consistent with the provisions of this section, make additional definitions of compensation available under this A 4(b). Any such additional definition is permissible under section 414(s) only if such definition satisfies the nondiscrimination rule set forth in A-4(b)(3).

(3) *Nondiscrimination rule.* An alternative definition of compensation described in A-4(b)(2) satisfies this

rule only if the compensation percentage for the employer's highly compensated employees is not greater than the compensation percentage for the employer's other employees. The compensation percentage for a group of employees is calculated by averaging the separately calculated compensation ratios for each employee in the group. An employee's compensation ratio is calculated by dividing the amount of the employee's compensation that is included in the alternative definition by the amount of such employee's compensation that is included in the basic definition of compensation (set forth in A-1 of this §1.414(s)-1 or (a) of this A-4) for the applicable period (defined in A-1(c) of this section).

There is a need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impractical to issue this Treasury decision with notice and public procedure under subsection (b) or section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved January 27, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on February 18, 1988, 8:45 a.m., and published in the issue of the Federal Register for February 19, 1988, 53 F.R. 4965)

Subchapter E.—Accounting Periods and Methods of Accounting
Part I.—Accounting Periods

Section 441.—Period for Computation of Taxable Income

26 CFR 1.441-1T: Period for computation of taxable income.

T.D. 8167

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953, PART 18-TEMPORARY INCOME TAX REGULATIONS UNDER THE SUBCHAPTER S REVISION ACT OF 1982

Taxable Years of Certain Entities

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the requirement that certain entities generally conform their taxable years to the taxable years of their owners. In addition, the text of the temporary regulations set forth in this document also serves as the text of the proposed regulations *** [page 929, this Bulletin]. Changes to the applicable law were made by the Tax Reform Act of 1986. The regulations affect personal service corporations, partnerships, and S corporations (and owners of those entities) and provide them with the guidance needed to comply with the law.

EFFECTIVE DATE: The temporary regulations are effective for taxable years beginning after December 31, 1986.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document amends the Income Tax Regulations (26 CFR Part 1) to provide temporary regulations interpreting section 806 of the Tax Reform Act of 1986 (the 1986 Act), Pub. L. No. 99-514, 100 Stat. 2362 [1986-3 C.B. (Vol. 1) 1, 279], which amended sections 441, 706(b) and 1378 of the Internal Revenue Code of 1986. In general, section 806 of the 1986 Act requires personal service corporations (PSCs), partnerships and S corporations to conform their taxable years to the taxable years of their owners. These temporary regulations provide guidance on the amendments to section 441, relating to (a) the definition of a PSC (section 441(i)), and (b) the special rules for applying a 52-53 week taxable year in the case of a partnership, S corporation, personal service corporation or the owners of such entities (section 441(f)). In addition, the temporary regulations provide special rules for the application of the amendments to sections 706(b) and 1378 with respect to the spread of income and expense items ratably over a 4-year period in the case of partners and shareholders of S corporations required in one taxable year to take into account items from more than one taxable year of a partnership or S corporation. Furthermore, the temporary regulations make conforming changes to the general provisions regarding taxable years under section 441.

EXPLANATION OF PROVISIONS

TAXABLE YEAR OF A PERSONAL SERVICE CORPORATION

Section 441(i)(1) provides that a PSC must use the calendar year as its taxable year unless the PSC establishes, to the satisfaction of the Secretary, a business purpose for using a different period as its taxable year. The temporary regulations provide that the taxable year of a PSC is the calendar year, unless the PSC's annual accounting period is a fiscal year and the PSC obtains the approval of the Commissioner to have such a fiscal year as its taxable year.

Approval of the Commissioner is not required in the case of a PSC changing its taxable year to the calendar year. For this purpose, a 52-53 week taxable year of a PSC ending with reference to the month of December will be treated as if it were the calendar year. In the case of a change to the calendar year, the PSC should notify the Internal Revenue Service of the change, in accordance with the applicable revenue procedure, such as, for example, Rev. Proc. 87-32, 1987-2 C.B. 396.

Approval of a fiscal year by the Commissioner requires the PSC to demonstrate a business purpose. For example, a PSC which demonstrates that the desired fiscal year coincides with its natural business year, as defined in section 4.01(1) of Rev. Proc. 87-32, is deemed to have established a business purpose to the satisfaction of the Secretary. In this regard, taxpayers should review Announcement 87-82, 1987-37 I.R.B. 30, for modifications to Rev. Proc. 87-32 extending the due date for PSCs requesting the Commissioner's approval to establish a business purpose.

DEFINITION OF A PERSONAL SERVICE CORPORATION

Under the temporary regulations, a taxpayer is a PSC for a taxable year only if (a) the taxpayer is a C corporation; (b) the principal activity of the taxpayer during the testing period for the taxable year is the performance of personal services; (c) the personal services are substantially performed by employee-owners; and (d) employee-owners hold more than 10 percent of the fair market value of the outstanding stock in the taxpayer as of the last day of the testing period for the taxable year.

Under the temporary regulations, the testing period for a taxable year is generally the taxable year preceding such taxable year. For example, a corporation that has been using June 30 as its taxable year will use the taxable year ended June 30, 1987, as the testing period for the taxable year beginning July 1, 1987.

With respect to a corporation whose first taxable year begins after December 31, 1986, the temporary regulations provide that the testing period for the corporation's first taxable year is the period beginning on the first day of the taxable year and ending on the earlier of (a) the last day of such taxable year, or (b) the last day of the calendar year in which the taxable year began.

PERFORMANCE OF PERSONAL SERVICES

During the course of drafting the temporary regulations, the Service considered many different approaches for determining whether an activity should be treated as the performance of a personal service. The approaches considered ranged from a narrow definition (*e.g.*, only activities described in section 448(d)(2)(A), relating to limitations on the use of the cash method of accounting) to a broad definition (*e.g.*, all activities except selling tangible property). After evaluating the various approaches, the Service concluded that the narrow definition of personal services provided in section 448(d)(2)(A) will apply for purposes of section 441(i).

Thus, under the temporary regulations any activity described in section 448(d)(2)(A) is treated as the performance of personal services. An activity not described in section 448(d)(2)(A) is not treated as the performance of personal services under the temporary regulations.

It should be noted, however, that although the temporary regulations provide that an activity is treated as the performance of personal services by reference to section 448(d)(2)(A), the definition of the term "personal service corporation" under these temporary regulations is different from the definition of the term "qualified personal service corporation" under section 448(d)(2). The principal differences relate to ownership requirements and the necessary percentage of personal service activities.

PRINCIPAL ACTIVITY

The temporary regulations provide that the corporation's principal activity during the testing period will be the performance of personal services if the total amount of the corporation's compensation cost for such taxable year that is attributable to its personal service activities exceeds 50 percent of the corporation's total compensation cost. Compensation cost is defined as (a) salaries and wages, and (b) other amounts attributable to services rendered in the course of employment. However, compensation cost does not include amounts attributable to a plan, qualified under section 401(a) or 403(a), or defined in section 408(k).

SERVICES SUBSTANTIALLY PERFORMED BY EMPLOYEE-OWNERS

The temporary regulations provide that the personal services performed by a corporation during a testing period will be treated as substantially performed by employee-owners of the corporation if more than 20 percent of the corporation's compensation cost with respect to personal services is attributable to employee-owners. Such determination is to be made by the taxpayer in any reasonable and consistent manner.

In the process of drafting the temporary regulations, the Service received many informal comments relating to the appropriate percentage for determining "substantially performed." Most of the commentators suggested that the term "substantially" should be interpreted as "substantially all." "Substantially all" would imply a very high percentage of services performed by employee-owners whereas "substantially" would imply a lower percentage. Given that the term "substantially" is used in the Code rather than the term "substantially all," the temporary regulations use 20 percent as the threshold for determining whether services are substantially performed by employee-owners.

Temporary regulations (§1.441-3T) issued under the authority to prescribe rules relating to the 52-53-week taxable year were published February 5, 1987 (52 FR 3615). Those temporary regulations interpreted the phrase "substantially performed by employee-owners" by using a 10 percent time test. That test was limited to taxpayers that desired to use a 52-53 week taxable year for a short taxable year ending on or before January 5, 1987. Upon further review, the Service determined that the 10 percent time test is inappropriate for purposes of interpreting section 441(i), because that test does not adequately weight the relative contributions of the various employees, in particular the employee-owners. For example, under the time test, an hour billed at $100/hour by an employee-owner of a law firm (that is a C corporation) is treated the same as an hour of a junior associate that may be billed at $40/hour. A compensation test, however, provides a weighted approach to measure relative performance of personal services. In addition to changing the measurement base from time spent to compensation, these temporary regulations differ from the 10 percent time test provided in §1.441-3T by (a) increasing the percentage from 10 percent to 20 percent, and (b) including the compensation cost for all employees involved in the corporation's personal service activity in the 20 percent calculation rather than including only compensation cost that is "directly and intrinsically related" to the providing of personal services.

Under the temporary regulations, a person is an employee-owner if that person is an employee on any day of the testing period, and the person owns any stock of the corporation on any day of the testing period. Attribution rules in section 318, as modified, apply for purposes of determining stock ownership. In addition, any person who is an owner and performs services for or on behalf of the corporation shall be treated as an employee for purposes of this rule, even if the legal form of that person's relationship to the corporation is such that he or she would be considered an independent contractor for other purposes.

52-53-WEEK TAXABLE YEAR

Section 441(f)(3) provides that the Secretary may by regulation provide terms and conditions for the application of the rules relating to the 52-53-week taxable year of a partnership, S corporation, personal service corporation, or any owner of such an entity.

The temporary regulations provide rules for cases in which the taxable year of a partnership and a partner, or an S corporation and an S corporation shareholder, or a personal service corporation and an employer-owner, end with or with reference to the same calendar month. Under the temporary regulations, in certain cases the taxable year of a partner, S corporation shareholder, or employee-owner will be deemed to end on the last day of the partnership's, S corporation's, or PSC's taxable year. For example, a calendar year partner in a 52-53-week partnership with a January 3, 1988 year end will be required to include in his 1987 income tax return his distributive share of partnership income for the taxable year ended January 3, 1988.

4-YEAR SPREAD

The temporary regulations provide that partners and S corporation shareholders may spread items of income and expense if (a) the items of income and expense are attributable to a partnership or S corporation that is required under section 806 of the 1986 Act to change its taxable year for the first taxable year beginning after December 31, 1986, and (b) the partner or S corporation would be required under the temporary regulations to include in one taxable year the items from more than one taxable year of the partnership or S corporation. The temporary regulations define the terms "income items" and "expense items" and provide other guidance with respect to section 806 of the 1986 Act.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis therefore is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

* * * * *

Amendments to the regulations

For the reasons set out in the preamble, Subchapter A, Parts 1 and 18 of Title 26, Chapter 1 of the Code of Federal Regulations is amended as set forth below:

INCOME TAX REGULATIONS

(26 CFR Part 1)

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. *** Section 1.441-2T also issued under 26 U.S.C. 441(f).

Par. 2. Section 1.441-1 is redesignated as §1.441-1T and amended by revising the caption, revising paragraphs (b), (f), and (g), and adding a new paragraph (h) to read as follows:

§1.441-1T Period for computation of taxable income (temporary).

* * * * *

(b)*Taxable year*—(1) *Definition of taxable year*—(i) *In general.* Except as otherwise provided in this paragraph (b)(1), the term "taxable year" means—

(A) The taxpayer's annual accounting period if it is a calendar year or a fiscal year; or

(B) The calendar year if section 441(g) (relating to taxpayers who keep no books or have no accounting period) applies. Except as provided in administrative provisions of the Internal Revenue laws, a taxable year may not cover a period of more than 12 calendar months. If a return is made under section 443 for a period of less than 12 months (a "short period"), the taxable year is the short period for which the return is made.

(ii) *Special rules for certain entities.* The general rule provided in paragraph (b)(1)(i) of this section may be modified by the Internal Revenue laws or regulations. For example, special rules are provided for the following taxpayers—

(A) In the case of personal service corporations, the applicable rules are contained in §1.441-4T.

(B) In the case of partnerships, the applicable rules are contained in §1.706-1T.

(C) In the case of S corporations, the applicable rules are contained in section 1378.

(D) In the case of members of an affiliated group which makes a consolidated return, the applicable rules are contained in §1.1502-76 and paragraph (d) of §1.442-1.

(E) In the case of trusts, the applicable rules are contained in section 645.

(F) In the case of real estate investment trusts, the applicable rules are contained in section 859.

(G) In the case of real estate mortgage investment conduits, the applicable rules are contained in section 860D(a)(5).

(H) In the case of FSCs or DISCs, the applicable rules are contained in section 441(h).

(2) *Adoption of taxable year.* A new taxpayer adopts a taxable year or on before the time prescribed by law (not including extensions) for the filing of the taxpayer's first return and may adopt, without prior approval, any taxable year that satisfies the requirements of section 441 and this section.

(3) *Change in taxable year*—(i) *General rule.* After a taxpayer has adopted a taxable year, such year must be used in computing taxable income and making returns for all subsequent years unless prior approval is obtained from the Commissioner to make a change or unless a change is otherwise permitted or required under the Internal Revenue laws or regulations. See section 442 and §1.442-1. Also see paragraph (b)(4) of this section.

(ii) *Change in taxable year required by the Tax Reform Act of 1986.* Procedures for entities (certain personal service corporations, partnerships and S corporations) required to change their taxable year under section 806 of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2362, are provided in Rev. Proc. 87-32, 1987-2 C.B. 396, or successor revenue procedures.

(4) *Retention of taxable year*—(i) *In general.* In certain cases, taxpayers will be required under the Internal Revenue laws or regulations to change their taxable year unless they establish a business purpose for retaining their current taxable year. For example, corporations electing to be S corporations, corporations that are personal service corporations for the first time, and certain partnerships with new partners may be required to change their taxable year unless they establish a business purpose for retaining their current taxable year.

(ii) *Section 806 of the Tax Reform Act of 1986.* Rev. Proc. 87-32 provides (and any successor revenue procedure would provide) procedures for certain entities (i.e., personal service corporations, partnerships and S corporations) requesting the Commissioner's approval to retain a fiscal year when such entity would otherwise by required to change its taxable year under section 806 of the Tax Reform Act of 1986. In addition, personal service corporations should see Announcement 87-82, 1987-37 I.R.B. 30, for modifications to Rev. Proc. 87-32 extending the due date for personal service corporations requesting the Commissioner's approval to establish a business purpose.

(f) *Election of year consisting of 52-53 weeks.* For rules relating to the 52-53-week taxable year, see §§1.441-2T, 1.441-3T, and 1.441-4T.

(g) *No books kept; no accounting period.* Except as otherwise provided in the Internal Revenue laws or regulations, the taxpayer's taxable year shall be the calendar year if—

(1) The taxpayer keeps no books;

(2) The taxpayer does not have an annual accounting period (as defined in section 441(c) and paragraph (c) of this section); or

(3) The taxpayer has an annual accounting period, but such period does not qualify as a fiscal year (as defined in section 441(e) and paragraph (e) of this section).

For purposes of paragraph (g)(1) of this section, the keeping of books does not require that records be bound. Records which are sufficient to reflect income adequately and clearly on the basis of an annual accounting period will be regarded as the keeping of books. A taxpayer whose taxable year is required to be a calendar year under section 441(g) and this paragraph (g) may not adopt a fiscal year without obtaining prior approval from the Commissioner. See section 442 and §1.442-1T(a)(2).

(h) *Effective date.* This section is effective for taxable years beginning after December 31, 1986. See 26 CFR 1.441-1 (revised as of April 1, 1987) for rules applicable to taxable years beginning before January 1, 1987.

Par. 3. Section 1.441-2 is redesignated as §1.441-2T and amended by revising the caption and paragraph (e) to read as follows:

§1.441-2T Election of year consisting of 52-53 weeks (temporary.

* * * * *

(e) *Partnerships, S corporations, and personal service corporations*—(1) *In general.* Paragraph (e) of this section applies if a partnership, partner, S corporation, S corporation shareholder, personal service corporation (within the meaning of §1.441-4T(d)), or employee-owner (within the meaning of §1.441-4T(h)) uses a 52-53-week taxable year.

(2) *Treatment of taxable years ending with reference to the same calendar month*—(i) *Timing of partners taking into account partnership items.* If the taxable year of a partnership and a partner end with reference to the same calendar month, then for purposes of determining the taxable year in which a partner takes into account—

(A) Items described in section 702, and

(B) Items that are deductible by the partnership (including items described in section 707(c)) and includible in the income of the partner, the partner's taxable year will be deemed to end on the last day of the partnership's taxable year.

(ii) *Timing of S shareholders taking into account S corporation items.* If the taxable year of an S corporation and a shareholder end with reference to the same calendar month, then for purposes of determining the taxable year in which a shareholder takes into account—

(A) Items described in section 1366(a), and

(B) Items that are deductible by the S corporation and includible in the income of the shareholder, the shareholder's taxable year will be deemed to end on the last day of the S corporation's taxable year.

(iii) *Personal service corporations and employee-owners.* If the taxable year of a personal service corporation and an employee-owner end with reference to the same calendar month, then for purposes of determining the taxable year in which an employee-owner takes into account items that are deductible by the personal service corporation and includible in the income of the employee-owner, the employee-owner's taxable year will be deemed to end on the last day of the personal service corporation's taxable year.

(3) *Automatic approval for partnerships and S corporations.* If a partnership or S corporation is required to use a taxable year ending with respect to the last day of a particular month and the partnership or S corporation desires to use a 52-53-week taxable year with reference to such month, the partnership or S corporation is granted automatic approval to use such 52-53-week taxable year. See §1.441-4T(b)(2)(ii) for a similar rule for personal service corporations.

(4) *Examples.* The provisions of paragraph (e)(2) of this section may be illustrated by the following examples.

Example (1). ABC Partnership uses a 52-53-week taxable year that ends on the Sunday nearest to December 31, and its partners, A, B, and C, are individual calendar year taxpayers. Assume that, for ABC's taxable year ending January 3, 1988, each partner's distributive share of ABC's taxable income is $10,000. Under section 706(a) and paragraph (e)(2)(i) of this section, for the taxable year ending December 31, 1987, A, B, and C each must include $10,000 in income with respect to the ABC year ending January 3, 1988. Similarly, if ABC makes a guaranteed payment to A on January 2, 1988, A must include the payment in income for his or her taxable year ending December 31, 1987.

Example (2). X, a personal service corporation, uses a 52-53-week taxable year that ends on the Sunday nearest to December 31, and all of the employee-owners of X are individual calendar year taxpayers. Assume that, for its taxable year ending January 3, 1988, X pays a bonus of $10,000 to each employee-owner. Under paragraph (e)(2)(iii) of this section, each employee-owner must include the bonus in income for the taxable year ending December 31, 1987.

(5) *Effective date.* Paragraph (e) of this section applies to taxable years beginning after December 31, 1986.

Par. 4. Section 1.441-2T is amended by revising the heading and text of paragraph (f) to read as follows:

§1.441-2T Election of year consisting of 52-53 weeks (temporary).

* * * * *

(f) *Special rules for 1986 and subsequent years.* For special rules relating to certain adoptions of, or changes to or from, a 52-53-week taxable year ending in 1986 or 1987, see §1.441-3T. For special rules relating to a 52-53-week taxable year beginning after December 31, 1986, see §1.441-2T(e).

Par. 5. Section 1.441-4T is added in the appropriate place.

§1.441-4T Taxable year of a personal service corporation (temporary).

(a) *Taxable year.* The taxable year of a personal service corporation (as defined in paragraph (d) of this section) is—

(1) The calendar year, or a "short period" (as provided in §1.441-1T (b)(1)(i)) ending December 31; or

(2) A fiscal year, or a short period (other than a short period provided in paragraph (a)(1) of this section), if the corporation obtains the approval of the Commissioner (in accordance with paragraph (c) of this section) for using such fiscal year.

(b) *Change in taxable year required*—(1)*In general.* For any taxable year after December 31, 1986, a taxpayer that is a personal service corporation for such taxable year must—

(i) Use a taxable year described in paragraph (a) of this section; or

(ii) Change to such a taxable year by using a short taxable year that ends on the last day of a taxable year described in paragraph (a) of this section.

(2) *Approval not required for change to a calendar year*—(i) *In general.* A personal service corporation may change its taxable year to the calendar year without the approval of the Commissioner. In such cases, however, the taxpayer should notify the Internal Revenue Service of the change in accordance with the provisions of the applicable revenue procedure. See, for example, section 5.02(1) of Rev. Proc. 87-32, 1987-2 C.B. 396.

(ii) *Special rule for 52-53-week taxable year ending with reference to the month of December.* For purposes of this section, a 52-53-week taxable year of a personal service corporation ending with reference to the month of December shall be treated as the calendar year. In order to assist in the processing of the retention or change in taxable year, taxpayers should refer to this special rule by either typing or legibly printing the following statement at the top of page 1 of the income tax return: "FILED UNDER §1.441-4T(b)(2)(ii)." See §1.441-2T(e) for special rules regarding 52-53-week taxable years for personal service corporations.

(3) *Examples.* The provisions of paragraph (b) of this section may be illustrated by the following examples.

Example (1). X corporation's last taxable year beginning before January 1, 1987, ends on January 31, 1987. In addition, X is a personal service corporation for its taxable year beginning February 1, 1987, and does not obtain the approval of the Commissioner for using a fiscal year. Thus, under paragraph (b)(1) of this section, X is required to change its taxable year to the calendar year by using a short taxable year that begins on February 1, 1987, and ends on December 31, 1987. Under paragraph (b)(2)(i) of this section, X may change its taxable year without the consent of the Commissioner, but should notify the Internal Revenue Service of the change in accordance with section 5.02(1) of Rev. Proc. 87-32.

Example (2). Assume the same facts as in example (1), except that for its taxable year beginning February 1, 1987, X obtains the approval of the Commissioner to change its annual accounting period to a fiscal year ending September 30. Under paragraph (b)(1) of this section, X must file a tax return for the short period from February 1, 1987, through September 30, 1987.

Example (3). Assume the same facts as in example (1), except that the first taxable year for which X is a personal service corporation is the taxable year that begins on February 1, 1990. Thus, for taxable years ending before that date, this section does not apply with respect to X. For its taxable year beginning on February 1, 1990, however, X will be required to comply with paragraph (b) of this section. If X does not obtain the approval of the Commissioner to use a fiscal year, X will be required to change its taxable year to the calendar year by using a short taxable year that ends on December 31, 1990.

Example (4). Assume the same facts as in example (1), except that X desires to change to a 52-53-week taxable year ending with reference to the month of December. Pursuant to paragraphs (b)(2)(i) and (b)(2)(ii) of this section, X may change its taxable year to a 52-53-week taxable year ending with reference to the month of December without the consent of the Commissioner, but should notify the Internal Revenue Service of the change in accordance with paragraph (b)(2)(ii) of this section.

(c) *Approval of a fiscal year.* A personal service corporation must establish to the satisfaction of the Commissioner a business purpose for using a fiscal year under paragraph (a)(2) of this section. Business purpose is established to the satisfaction of the Commissioner in the case of a personal service corporation that—

(1) Requests to use, or is using, a fiscal year that coincides with its natural business year, as defined in section 4.01(1) of Rev. Proc. 87-32, or successor revenue procedures, or

(2) Receives permission from the Commissioner to use the fiscal year by establishing a business purpose for the fiscal year under section 6.01 of Rev. Proc. 87-32, or successor revenue procedures. See also Rev. Rul. 87-57, 1987-2 C.B. 117. See Announcement 87-82 for modifications to Rev. Proc. 87-32 regarding due dates for personal service corporations filing applications and income tax returns for certain short taxable years beginning after December 31, 1986.

(d) *Personal service corporation for a taxable year*—(1) *In general.* For purposes of this section, a taxpayer is a personal service corporation for a taxable year only if—

(i) The taxpayer is a C corporation (as defined in section 1361(a)(2)) for the taxable year;

(ii) The principal activity of the taxpayer during the testing period for the taxable year is the performance of personal services;

(iii) During the testing period for the taxable year, such services are substantially performed by employee-owners; and

(iv) Employee-owners, as defined in paragraph (h) of this section, own (as determined under the attribution rules of section 318, except that "any" shall be substituted for "50 percent" in section 318(a)(2)(C)) more than 10 percent of the fair market value of the outstanding stock in the taxpayer on the last day of the testing period for the taxable year.

(2) *Testing period*—(i) *In general.* Except as otherwise provided in paragraph (d)(2)(ii) of this section, the testing period for a taxable year is the taxable year preceding such taxable year.

(ii) *New corporations.* The testing period for a taxpayer's first taxable year is the period beginning on the first day of such taxable year and ending on the earlier of—

(A) The last day of such taxable year; or

(B) The last day of the calendar year in which such taxable year begins.

(3) *Examples.* The provisions of paragraph (d)(2) of this section may be illustrated by the following examples.

Example (1). Corporation A has been in existence since 1980 and has used a January 31 taxable year for all taxable years beginning before 1987. For purposes of determining whether A is a personal service corporation for the taxable year beginning February 1, 1987, A's testing period under paragraph (d)(2)(i) of this section is the taxable year ending January 31, 1987.

Example (2). B corporation's first taxable year begins on June 1, 1987, and B desires to use a September 30 taxable year. However, if B is a personal service corporation, it must obtain the Commissioner's approval to use a September 30 taxable year. Pursuant to paragraph (d)(2)(ii) of this section, B's testing period for its first taxable year beginning June 1, 1987, is the period June 1, 1987 through September 30, 1987. Thus, if, based upon such testing period, B is a personal service corporation, B must obtain the Commissioner's permission to use a September 30 taxable year.

Example (3). The facts are the same as in example (2), except that B desires to use a March 31 taxable year. Pursuant to paragraph (d)(2)(ii) of this section, B's testing period for its first taxable year beginning June 1, 1987, is the period June 1, 1987, through December 31, 1987. Thus, if, based upon such testing period, B is a personal service corporation, B must obtain the Commissioner's permission to use a March 31 fiscal year.

(e) *Determination of whether an activity during the testing period is treated as the performance of personal services*—(1) *Activities described in section 448(d)(2)(A).* For purposes of this section, any activity of the taxpayer described in section 448(d)(2)(A) or the regulations thereunder will be treated as the performance of personal services. Therefore, any activity of the taxpayer that involves the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (as such fields are defined in the regulations interpreting section 448) will be treated as the performance of personal services for purposes of this section.

(2) *Activities not described in section 448(d)(2)(A).* For purposes of this section, any activity of the taxpayer not described in section 448(d)(2)(A) or the regulations thereunder will not be treated as the performance of personal services.

(f) *Principal activity*—(1) *General rule.* For purposes of this section, the principal activity of a corporation for any testing period will be considered to be the performance of personal services if the cost of the corporation's compensation (the "compensation cost") for such testing period that is attributable to its activities that are treated as the performance of personal services under paragraph (e) of this section exceeds 50 percent of the corporation's total compensation cost for such testing period.

(2) *Compensation cost.* For purposes of this section, the compensation cost of a corporation for a taxable year is equal to the sum of the following amounts allowable as a deduction, allocated to a long-term contract, or otherwise chargeable to a capital account by the corporation during such taxable year—

(i) Wages and salaries, and

(ii) Any other amounts attributable to services performed for or on behalf of the corporation by a person who is an employee of the corporation (including an owner of the corporation who is treated as an employee under paragraph (h)(2) of this section) during the testing period. Such amounts include, but are not limited to, amounts attributable to deferred compensation, commissions, bonuses, compensation includible in income under section 83, compensation for services based on a percentage of profits, and the cost of providing fringe benefits that are includible in income.

However, for purposes of this section, compensation cost does not include amounts attributable to a plan qualified under section 401(a) or 403(a), or to a simplified employee pension plan defined in section 408(k).

(3) *Attribution of compensation cost to personal service activity*—(i) *Employees involved only in the performance of personal services.* The compensation cost for employees involved only in the performance of activities that are treated as personal services under paragraph (e) of this section, or employees involved only in supporting the work of such employees, shall be considered to be attributable to the corporation's personal service activity.

(ii) *Employees involved only in activities that are not treated as the performance of personal services.* The compensation cost for employees involved only in the performance of activities that are not treated as personal services under paragraph (e) of this section, or for employees involved only in supporting the work of such employees, shall not be considered to be attributable to the corporation's personal service activity.

(iii) *Other employees.* The compensation cost for any employee who is not described in either paragraph (f)(3)(i) or paragraph (f)(3)(ii) of this section ("a mixed activity employee") shall be allocated as follows—

(A) *Compensation cost attributable to personal service activity.* That portion of the compensation cost for a mixed activity employee that is attributable to the corporation's personal service activity equals the compensation cost for such employee multiplied by the percentage of the total time worked for the corporation by such employee during the year that is attributable to activities of the corporation that are treated as the performance of personal services under paragraph (e) of this section. Such percentage shall be determined by the taxpayer in any reasonable and consistent manner. Time logs are not required unless maintained for other purposes;

(B) *Compensation cost not attributable to personal service activity.* That portion of the compensation cost for a mixed activity employee that shall not be considered to be attributable to the corporation's personal service activity is the compensation cost for such employee less the amount determined in paragraph (f)(3)(iii)(A) of this section.

(g) *Services substantially performed by employee-owners*—(1) *General rule.* Personal services are substantially performed during the testing period by employee-owners of the corporation if more than 20 percent of the corporation's compensation cost for such period attributable to its activities that are treated as the performance of personal services (within the meaning of paragraph (e) of this section), is attributable to personal services performed by employee-owners.

(2) *Compensation cost attributable to personal services.* For purposes of paragraph (g)(1) of this section—

(i) The corporation's compensation cost attributable to its activities that are treated as the performance of personal services shall be determined under paragraph (f)(3) of this section; and

(ii) The portion of the amount determined under paragraph (g)(2)(i) of this section that is attributable to personal services performed by employee-owners shall be determined by the taxpayer in any reasonable and consistent manner.

(3) *Examples.* The provisions of paragraph (g) of this section may be illustrated by the following examples.

Example (1). For its taxable year beginning February 1, 1987, Corporation A's testing period is the taxable year ending January 31, 1987. During such testing period, A's only activity was the performance of personal services. The total compensation cost of A (including compensation cost attributable to employee-owners) for the testing period was $1,000,000. The total compensation cost attributable to employee-owners of A for the testing period was $210,000. Pursuant to paragraph (g)(1) of this section, the employee-owners of A substantially performed the personal services of A during the testing period because the compensation cost of A's employee-owners was more than 20 percent of the total compensation cost for all of A's employees (including employee-owners).

Example (2). Corporation B has the same facts as corporation A in example (1), except that during the taxable year ending January 31, 1987, B also participated in an activity that would not be characterized as the performance of personal services under this section. The total compensation cost of B (including compensation cost attributable to employee-owners) for the testing period was $1,500,000 ($1,000,000 attributable to B's personal service activity and $500,000 attributable to B's other activity). The total compensation cost attributable to employee-owners of B for the testing period was $250,000 ($210,000 attributable to B's personal service activity and $40,000 attributable to B's other activity). Pursuant to paragraph (g)(1) of this section, the employee-owners of B substantially performed the personal services of B during the testing period because more than 20 percent of B's compensation cost during the testing period attributable to its personal service activities was attributable to personal services performed by employee-owners ($210,000).

(h) *Employee-owner defined*—(1) *General rule.* For purposes of this section, a person is an employee-owner of a corporation for a testing period if—

(i) The person is an employee of the corporation on any day of the testing period, and

(ii) The person owns any outstanding stock of the corporation on any day of the testing period.

(2) *Special rule for independent contractors who are owners.* Any person who is an owner of the corporation within the meaning of paragraph (h)(1)(ii) of this section and who performs personal services for or on behalf of the corporation shall be treated as an employee for purposes of this section, even if the legal form of that person's relationship to the corporation is such that he or she would be considered an independent contractor for other purposes.

(i) *Special rules for affiliated group filing consolidated return*—(1) *In general.* For purposes of applying this section to the members of an affiliated group of corporations filing a consolidated return for the taxable year—

(i) The members of the affiliated group shall be treated as a single corporation;

(ii) The employees of the members of the affiliated group shall be treated as employees of such single corporation; and

(iii) All of the stock, of the members of the affiliated group, that is not owned by any other member of the affiliated group shall be treated as the outstanding stock of such corporation.

(2) *Examples.* The provisions of this paragraph (i) may be illustrated by the following examples.

Example (1). The affiliated group AB, consisting of corporation A and its wholly owned subsidiary B, filed a consolidated Federal income tax return for the taxable year ending January 31, 1987, and AB is attempting to determine whether it is affected by this section for its taxable year beginning February 1, 1987. During the testing period (i.e., the taxable year ending January 31, 1987), A did not perform personal services while B's only activity was the performance of personal services. On the last day of the testing period, employees of A did not own any stock in A while some of B's employees own stock in A. In the aggregate, B's employees own 9 percent of A's stock on the last day of the testing period. Pursuant to paragraph (i)(1) of this section, this section is effectively applied on a consolidated basis to members of an affiliated group filing a consolidated Federal income tax return. Since the only employee-owners of AB are the employees of B and since B's employees do not own more than 10 percent of AB on the last day of the testing period, AB is not subject to the provisions of this section. Thus, AB is not required to determine on a consolidated basis whether, during the testing period, (a) its principal activity is the providing of personal services, or (b) the personal services are substantially performed by employee-owners.

Example (2). The facts are the same as in example (1), except that on the last day of the testing period A owns only 80 percent of B. The remaining 20 percent of B is owned by employees of B. The fair market value of A, including its 80 percent interest in B, as of the last day of the testing period, is $100,000. In addition, the fair market value of the 20 percent interest in B owned by B's employees is $5,000 as of the last day of the testing period. Pursuant to paragraph (d)(1)(iv) and paragraph (i)(1) of this section, AB must determine whether the employee-owners of A and B (*i.e.*, B's employees) own more than 10 percent of the fair market value of A and B as of the last day of the testing period. Since the $14,000 [($100,000 × .09) + $5,000] fair market value of the stock held by B's employees is greater than 10 percent of the $105,000 ($100,000 + $5,000) aggregate fair market value of A and B as of the last day of the testing period, AB may be subject to this section if, on a consolidated basis during the testing period, (a) the principal activity of AB is the performance of personal services and (b) the personal services are substantially performed by employee-owners.

(j) *Effective date.* This section applies to taxable years beginning after December 31, 1986.

Par. 6. Section 1.702-3T is added in the appropriate place.

§1.702-3T 4-year spread (temporary).

(a) *Applicability.* This section applies to a partner in a partnership if—

(1) The partnership is required by section 806 of the Tax Reform Act of 1986 (the 1986 Act), Pub. L. No. 99-514, 100 Stat. 2362, to change its taxable year for the first taxable year beginning after December 31, 1986 (partnerhip's year of change); and

(2) As a result of such change in taxable year, items from more than one taxable year of the partnership would, but for the provisions of this section, be included in the taxable year of the partner with or within which the partnership's year of change ends.

(b) *Partner's treatment of items from the partnership's year of change*—(1) *In general.* Except as provided in paragraph (c) of this section, if a partner's share of "income items" exceeds the partner's share of "expense items," the partner's share of each and every income and expense item shall be taken into account ratably (and retain its character) over the partner's first 4 taxable years beginning with the partner's taxable year with or within which the partnership's year of change ends.

(2) *Definitions*—(i) *Income items.* For purposes of this section, the term "income items" means the sum of—

(A) The partner's distributive share of taxable income (exclusive of separately stated items) from the partnership's year of change,

(B) The partner's distributive share of all separately stated income or gain items from the partnership's year of change, and

(C) Any amount includible in the partner's income under section 707(c) on account of payments during the partnership's year of change.

(ii) *Expense items.* For purposes of this section, the term "expense items" means the sum of—

(A) The partner's distributive share of taxable loss (exclusive of separately stated items) from the partnership's year of change, and

(B) The partner's distributive share of all separately stated items of loss or deduction from the partnership's year of change.

(c) *Electing out of 4-year spread.* A partner may elect out of the rules of paragraph (b) of this section by meeting the requirements of §5h.5 (temporary regulations relating to elections under the Tax Reform Act of 1986).

(d) *Special rules for a partner that is a partnership or S corporation*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, a partner that is a partnership or S corporation may, if otherwise eligible, use the 4-year spread (with respect to partnership interests owned by the partner) described in this section.

(2) *Certain partners prohibited from using 4-year spread*—(i) *In general.* Except as provided in paragraph (d)(2)(ii) of this section, a partner that is a partnership or S corporation may not use the 4-year spread (with respect to partnership interests owned by the partner) if such partner is also changing its taxable year pursuant to section 806 of the 1986 Act.

(ii) *Exception.* If a partner's year of change does not include any income or expense items with respect to the partnership's year of change, such partner may, if otherwise eligible, use the 4-year spread (with respect to such partnership interest) described in this section even though the partner is a partnership or S corporation. See examples (13) and (14) in paragraph (h) of this section.

(e) *Basis of partner's interest.* The basis of a partner's interest in a partnership shall be determined as if the partner elected not to spread the partnership items over 4 years, regardless of whether such election was in fact made. Thus, for example, if a partner is eligible for the 4-year spread and does not elect out of the 4-year spread pursuant to paragraph (c) of this section, the partner's basis in the partnership interest will be increased in the first year of the 4-year spread period by an amount equal to the excess of the income items over the expense items. However, the partner's basis will not be increased again, with respect to the unamortized income and expense items, as they are amortized over the 4-year spread period.

(f) *Effect on other provisions of the Code.* Except as provided in paragraph (e) of this section, determinations with respect to a partner, for purposes of other provisions of the Code, must be made with regard to the manner in which partnership items are taken into account under the rules of this section. Thus, for example, a partner who does not elect out of the 4-year spread must take into account, for purposes of determining net earnings from self-employment under section 1402(a) for a taxable year, only the ratable portion of partnership items for that taxable year.

(g) *Treatment of dispositions*—(1) *In general.* If a partnership interest is disposed of before the last taxable year in the 4-year spread period, unamortized income and expense items that are attributable to the interest disposed of and that would be taken into account by the partner for subsequent taxable years in the 4-year spread period shall be taken into account by the partner as determined under paragraph (g)(2) of this section. For purposes of this section, the term "disposed of" means any transfer, including (but not limited to) transfers by sale, exchange, gift, and by reason of death.

(2) *Year unamortized items taken into account.* (i) *In general.* If, at the end of a partner's taxable year, the fraction determined under paragraph (g)(2)(ii) of this section is—

(A) Greater than 2/3, the partner must continue to take the unamortized income and expense items into account ratably over the 4-year spread period;

(B) Greater than 1/3 but less than or equal to 2/3, the partner must, in addition to its ratable amortization, take into account in such year 50 percent of the income and expense items that would otherwise be unamortized at the end of such year (however, this paragraph (g)(2)(i)(B) is only applied once with respect to a partner's interest in a particular partnership); or

(C) Less than or equal to 1/3, the partner must take into account the entire balance of unamortized income and expense items in such year.

(ii) *Determination of fraction.* For purposes of paragraph (g)(2)(i) of this section, the numerator of the fraction is the partner's proportionate interest in the partnership at the end of the partner's taxable year and the denominator is the partner's proportionate interest in the partnership as of the last day of the partnership's year of change.

(h) *Examples.* The provisions of this section may be illustrated by the following examples.

Example (1). Assume that P1, a partnership with a taxable year ending September 30, is required by the 1986 Act to change its taxable year to a calendar year. All of the partners of P1 are individual taxpayers reporting on a calendar year. P1 is required to change to a calendar year for its taxable year beginning October 1, 1987, and to file a return for the short taxable year ending December 31, 1987. Based on the above facts, the partners of P1 are required to include the items from more than one taxable year of P1 in income for their 1987 taxable year. Thus, under paragraph (b) of this section, if a partner's share of income items exceeds the partner's share of expense items, the partner's share of each and every income and expense item shall be taken into account ratably by such partner in each of the partner's first four taxable years beginning with the partner's 1987 taxable year, unless such partner elects under paragraph (c) of this section to include all such amounts in his 1987 taxable year.

Example (2). Assume the same facts as in example (1), except P1 is a personal service corporation with all of its employee-owners reporting n a calendar year. Although P1 is required to change to a calendar year for its taxable year beginning October 1, 1987, neither P1 nor its employee-owners obtain the benefits of a 4-year spread. Pursuant to section 806(e)(2)(C) of the 1986 Act, the 4-year spread provision is only applicable to short taxable years of partnerships and S corporations required to change their taxable year under the 1986 Act.

Example (3). Assume the same facts as example (1) and that I is one of the individual partners of P1. Further assume that I's distributive share of P1's taxable income for the short taxable year ended December 31, 1987 (*i.e.*, P1's year of change), is $10,000. In addition, I has $8,000 of separately stated expense from P1's year of change. Since I's income items (*i.e.*, $10,000 of taxable income) exceed I's expense items (*i.e.*, $8,000 of separately stated expense) attributable to P1's year of change, I is eligible for the 4-year spread provided by this section. If I does not elect out of the 4-year spread, I will recognize $2,500 of taxable income and $2,000 of separately stated expense in his 1987 calendar year return. Assuming I does not dispose of his partnership interest in P1 by December 31, 1989, the remaining $7,500 of taxable income and $6,000 of separately stated expense will be amortized (and retain its character) over I's next three taxable years (*i.e.*, 1988, 1989 and 1990).

Example (4). Assume the same facts as example (3), except that I disposes of his entire interest in P1 during 1988. Pursuant to paragraph (g) of this section, I would recognize $7,500 of taxable income and $6,000 of separately stated expense in his 1988 calendar year return.

Example (5). Assume the same facts as in example (3), except that I disposes of 50 percent of his interest in P1 during 1989. Pursuant to paragraph (g) of this section, I would recognize $3,750 of taxable income in his 1989 calendar year return ($2,500 ratable portion for 1989 plus 50 percent of the $2,500 of income items that would otherwise be unamortized at the end of 1989). I would also recognize $3,000 of separately stated expense items in 1989 ($2,000 ratable portion for 1989 plus 50 percent of the $2,000 of separately stated expense items that would otherwise be unamortized at the end of 1989).

Example (6). Assume the same facts as in example (1), except that X, a personal service corporation as defined in section 441(i), is a partner of P1. X is a calendar year taxpayer, and thus is not required to change its taxable year under the 1986 Act. The same result occurs as in example 1 (*i.e.*, unless X elects to the contrary, X is required to include one fourth of its share of income and expense items from P1's year of change in the first four taxable years of X beginning with the 1987 taxable year).

Example (7). Assume the same facts as in example (6), except that X is a fiscal year personal service corporation with a taxable year ending September 30. X is required under the 1986 Act to change to a calendar year for its taxable year beginning October 1, 1987, and to file a return for its short year ending December 31, 1987. Based on the above facts, X is not required to include the items from more than one taxable year of P1 in any one taxable year of X. Thus, the provisions of this section do not apply to X, and X is required to include the full amount of income and expense items from P1's year of change in X's taxable income for X's short year ending December 31. Under section 443 of the Code, X is required to annualize the taxable income for its short year ending December 31, 1987.

Example (8). Assume that P2 is a partnership with a taxable year ending September 30. Under the 1986 Act, P2 would have been required to change its taxable year to a calendar year, effective for the taxable year beginning October 1, 1987. However, P2 properly changed its taxable year to a calendar year for the year beginning October 1, 1986, and filed a return for the short period ending December 31, 1986. The provisions of the 1986 Act do not apply to P2 because the short year ending December 31, 1986, was not required by the amendments made by section 806 of the 1986 Act. Thus, the partners of P2 are required to take all items of income and expense for the short taxable year ending December 31, 1986, into account for the taxable year with or within which such short year ends.

Example (9). Assume that P3 is a partnership with a taxable year ending March 31 and I, a calendar year individual, is a partner in P3. Under the 1986 Act, P3 would have been required to change its taxable year to a calendar year. However, under Rev. Proc. 87-32, P3 establishes and changes to a natural business year beginning with the taxable year ending June 30, 1987. Thus, P3 is required to change its taxable year under section 806 of the 1986 Act, and I is required to include items from more than one taxable year of P3 in one of her taxable years. Furthermore, I's share of P3's income items exceeds her share of P3's expense items for the short period April 1, 1987 through June 30, 1987. Accordingly, under this section, unless I elects to the contrary, I is required to take one fourth of her share of items of income and expense from P3's short taxable year ending June 30, 1987 into account for her taxable year ending December 31, 1987.

Example (10). Assume that P4 is a partnership with a taxable year ending March 31. Y, a C corporation, owns a 51 percent interest in the profits and capital of P4. Y reports its income on the basis of a taxable year ending March 31. P4 establishes and changes to a natural business year beginning with the taxable year ending June 30, 1987, under Rev. Proc. 87-32. Under the above facts, P4 is not required to change its taxable year because its March 31 taxable year was the taxable year of Y, the partner owning a majority of the partnership's profits and capital. Therefore, the remaining partners of P4 owning 49 percent of the profits and capital are not permitted the 4-year spread of the items of income and expense with respect to the short year, even though they may be required to include their distributive share of P4's items from more than one taxable year in one of their years.

Example (11). Assume that X and Y are C corporations with taxable years ending June 30. Each owns a 50-percent interest in the profits and capital of partnership P5. P5 has a taxable year ending March 31. Assume that P5 cannot establish a business purpose in order to retain a taxable year ending March 31, and thus P5 must change to a June 30 taxable year, the taxable year of its partners. Furthermore, assume that X's share of P5's income items exeeds its share of P5's expense items for P5's short taxable year ending June 30, 1987. Unless X elects out of the 4-year spread, the taxable year ending June 30, 1987, is the first of the four taxable years in which X must take into account its share of the items of income and expenses resulting from P5's short taxable year ending June 30, 1987.

Example (12). Assume that I, an individual who reports income on the basis of the calendar year, is a partner in two partnerships, P6 and P7. Both partnerships have a taxable year ending September 30. Neither partnership can establish a business purpose for retaining its taxable year. Consequently, each partnership will change its taxable year to December 31, for the taxable year beginning October 1, 1987. The election to avoid a 4-year spread is made at the partner level; in addition, a partner may make such elections on a partnership-by-partnership basis. Thus, assuming I is eligible to obtain the 4-year spread with respect to income and expense items from partnerships P6 and P7, I may use the 4-year spread with respect to items from P6, while not using the 4-year spread with respect to items from P7.

Example (13). I, an individual taxpayer using a calendar year, owns an interest in P8, a partnership using a taxable year ending June 30. Furthermore, P8 owns an interest in P9, a partnership with a taxable year ending March 31. Under section 806 of the 1986 Act, P8 will be required to change to a taxable year ending December 31, while P9 will be required to change to a taxable year ending June 30. As a result, P8's year of change will be July 1 through December 31, 1987, while P9's year of change will be from April 1 through June 30, 1987. Since P9's year of change does not end with or within P8's year of change, paragraph (d)(2) of this section does not prevent P8 from obtaining a 4-year spread with respect to its interest in P9.

Example (14). the facts are the same as in example (13), except that P9 has a taxable year ending September 30, and under the 1986 Act P9 is required to change to a taxable year ending December 31. Therefore, P9's year of change will be from October 1, 1987 through December 31, 1987. Although P8's year of change from July 1, 1987 through December 31, 1987 includes two taxable years of P9 (*i.e.*, October 1, 1986 through September 30, 1987 and October 1, 1987 through December 31, 1987), paragraph (d)(2) of this section prohibits P8 from using the 4-year spread with respect to its interest in P9, because P9's year of change ends with or within P8's year of change.

Par. 7. The authority for Part 18 continues to read in part:

Authority: 26 U.S.C. 7805. ***

Par. 8. Sections 18.1366-1, 2, 3 and 4 are added and reserved and section 18.1366-5 is added in the appropriate place.

§18.1366-1 [Reserved].

§18.1366-2 [Reserved].

§18.1366-3 [Reserved].

§18.1366-4 [Reserved].

§18.1366-5 4-year spread.

(a) *Applicability.* This section applies to a shareholder in an S corporation if—

(1) The S corporation is required by section 806 of the Tax Reform Act of 1986 (the 1986 Act), Pub. L. No. 99-514, 100 Stat. 2362, to change its taxable year for the first taxable year beginning after December 31, 1986 (S corporation's year of change);

(2) As a result of such change in taxable year, items from more than one taxable year of the S corporation would, but for the provisions of this section, be included in the taxable year of the shareholder with or within which the S corporation's year of change ends; and

(3) The corporation was an S corporation for a taxable year beginning in 1986.

(b) *Shareholder's treatment of items from the S corporation's year of change*—(1) *In general.* Except as provided in paragraph (c) of this section, if a shareholder's share of "income items" exceeds the shareholder's share of "expense items," the shareholder's share of each and every income and expense item shall be taken into account ratably (and retain its character) over the shareholder's first 4 taxable years beginning with the shareholder's taxable year with or within which the S corporation's year of change ends.

(2) *Definitions*—(i) *Income items.* For purposes of this section, the term "income items" means the sum of—

(A) The shareholder's pro rata share of the nonseparately computer income from the S corporation's year of change, and

(B) The shareholder's pro rata share of the items of income (including tax-exempt income), from the S corporation's year of change, the separate treatment of which items of income could affect the liability for tax of any shareholder.

(ii) *Expense items.* For purposes of this section, the term "expense items" means the sum of—

(A) The shareholder's pro rata share of the nonseparately computed loss from the S corporation's year of change, and

(B) The shareholder's pro rata share of the items of loss and deduction from the S corporation's year of change, the separate treatment of which items of loss and deduction could affect the liability for tax of any shareholder.

(c) *Electing out of 4-year spread.* A shareholder may elect out of the rules of paragraph (b) of this section by meeting the requirements of §5h.5 (temporary regulations relating to elections under the Tax Reform Act of 1986).

(d) *Basis of shareholder's interest.* The basis of a shareholder's interest in an S corporation shall be determined as if the S corporation shareholder elected not to spread the partnership items over 4 years, regardless of whether such election was in fact made. Thus, for example, if an S corporation shareholder is eligible for the 4-year spread and does not elect out of the 4-year spread pursuant to paragraph (c) of this section, the shareholder's basis in the S corporation interest will be increased in the first year of the 4-year spread period by an amount equal to the excess of the income items over the expense items. However, the shareholder's basis will not be increased again, with respect to the unamortized income and expense items, as they are amortized over the 4-year spread period.

(e) *Effect on other provisions of the Code.* Except as provided in paragraph (d) of this section, determinations with respect to a shareholder, for purposes of other provisions of the Code, must be made with regard to the manner in which S corporation items are taken into account under the rules of this section. Thus, for example, a shareholder who does not elect out of the 4-year spread must take into account, for purposes of determining his or her charitable contribution deduction limitations for a taxable year, only the ratable portion of S corporation items for that taxable year.

(f) *Treatment of dispositions*—(1) *In general.* If S corporation stock is disposed of before the last taxable year in the 4-year spread period, unamortized income and expense items that are attributable to the interest disposed of and that would be taken in account by the shareholder for subsequent taxable years in the 4-year spread period shall be taken into account by the shareholder as determined under paragraph (f)(2) of this section. For purposes of this section, the term "disposed of" means any transfer, including (but not limited to) transfers by sale, exchange, gift, and by reason of death.

(2) *Year unamortized items taken into account*—(i) *In general.* If, at the end of a shareholder's taxable year, the fraction determined under paragraph (f)(3)(ii) of this section is—

(A) Greater than 2/3, the shareholder must continue to take the unamortized income and expense items into account ratably over the 4-year spread period;

(B) Greater than 1/3 but less than or equal to 2/3, the shareholder must, in addition to its ratable amortization, take into account in such year 50 percent of the income and expense items that would otherwise be unamortized at the end of such year (however, this paragraph (f)(2)(i)(B) is only applied once with respect to an S shareholder's interest in a particular S corporation); or

(C) Less than or equal to 1/3, the shareholder must take into account the entire balance of unamortized income and expense items in such year.

(ii) *Determination of fraction.* For purposes of paragraph (f)(2)(i) of this section, the numerator of the fraction is the shareholder's proportionate interest in the S corporation at the end of the shareholder's taxable year and the denominator is the shareholder's proportionate interest in the S corporation as of the last day of the S corporation's year of change.

(g) *Examples.* The provisions of this section may be illustrated by the following examples.

Example (1). Assume that S1, an S corporation with a taxable year ending September 30, is required by the 1986 Act to change its taxable year to a calendar year. All of the shareholders of S1 are individual taxpayers reporting on a calendar year. S1 is required to change to a calendar year for its taxable year beginning October 1, 1987, and to file a return for the short taxable year ending December 31, 1987. Based on the above facts, the shareholders of S1 are required to include the items from more than one taxable year of S1 in income for their 1987 taxable year. Thus, under paragraph (b) of this section, if a shareholder's share of income items exceeds the shareholder's share of expense items, the shareholder's share of each and every income and expense item shall be taken into account ratably by such shareholder in each of the shareholder's first four taxable years beginning with the shareholder's 1987 taxable year, unless such shareholder elects under paragraph (c) of this section to include all such amounts in his 1987 taxable year.

Example (2). Assume the same facts as in example (1), except S1 is a personal service corporation with all of its employee-owners reporting on a calendar year. Although S1 is required to change to a calendar year for its taxable year beginning October 1, 1987, neither S1 nor its employee-owners obtain the benefits of a 4-year spread. Pursuant to section 806(e)(2)(C) of the 1986 Act, the 4-year spread provision is only applicable to short taxable years of partnerships and S corporations required to change their taxable year under the 1986 Act.

Example (3). Assume the same facts as example (1) and that I is one of the individual shareholders of S1. Further assume that I's share of the nonseparately computed income from S1's taxable income for the short taxable year ended December 31, 1987 (*i.e.*, S1's year of change) is $10,000. In addition, I has $8,000 of nonseparately computed loss from S1's year of change. Since I's income items (*i.e.*, $10,000 of taxable income) exceed I's expense items (*i.e.*, $8,000 of loss) attributable to S1's year of change, I is eligible for the 4-year spread provided by this section. If I does not elect out of the 4-year spread, I will recognize $2,500 of taxable income and $2,000 of loss in his 1987 calendar year return. Assuming I does not dispose of his S corporation interest in S1 by December 31, 1989, the remaining $7,500 of taxable income and $6,000 of loss will be amortized (and retain its character) over I's next three taxable years (*i.e.*, 1988, 1989 and 1990).

Example (4). Assume the same facts as in example (3), except that I disposes of his entire interest in S1 during 1988. Pursuant to paragraph (f) of this section, I would recognize $7,500 of taxable income and $6,000 of loss in his 1988 calendar year return.

Example (5). Assume the same facts as in example (3), except that I disposes of 50 percent of his stock in S1 during 1989. Pursuant to paragraph (f) of this section, I would recognize $3,750 of taxable income in his 1989 calendar year return ($2,500 ratable portion for 1989 plus 50 percent of the $2,500 of income items that would otherwise be unamortized at the end of 1989). I would also recognize $3,000 of separately stated expense items in 1989 ($2,000 ratable portion for 1989 plus 50 percent of the $2,000 of separately stated expense items that would otherwise be unamortized at the end of 1989).

Example (6). Assume that S2 is an S corporation with a taxable year ending September 30. Under the 1986 Act, S2 would have been required to change its taxable year to a calendar year, effective for the taxable year beginning October 1, 1987. However, S2 properly changed its taxable year to a calendar year for the year beginning October 1, 1986, and filed a return for the short period ending December 31, 1986. The provisions of the Act do not apply to S2 because the short year ending December 31, 1986 was not required by the amendments made by section 806 of the 1986 Act. Thus, the shareholders of S2 are required to take all items of income and expense for the short taxable year ending December 31, 1986, into account for the taxable year with or within which such short year ends.

Example (7). Assume that S3 is an S corporation with a taxable year ending March 31 and I, a calendar year individual, is a shareholder in S3. Under the 1986 Act, S3 would have been required to change its taxable year to a calendar year. However, under Rev. Proc. 87-32, S3 establishes and changes to a natural business year beginning with the taxable year ending June 30, 1987. Thus, S3 is required to change its taxable year under section 806 of the 1986 Act, and I is required to include items from more than one taxable year of S3 in one of her taxable years. Furthermore, I's share of S3's income items exceeds her share of S3's expense items for the short period April 1, 1987 through June 30, 1987. Accordingly, under this section, unless I elects to the contrary, I is required to take one fourth of her share of items of income and expense from S3's short taxable year ending June 30, 1987, into account for her taxable year ending December 31, 1987.

Example (8). Assume that S4 is an S corporation with a taxable year ending March 31. I, an individual, owns 51 percent of the stock of S4. I reports her income on the basis of a taxable year ending March 31. S4 establishes and changes to a natural business year beginning with the taxable year ending June 30, 1987, under Rev. Proc. 87-32. Under the above facts, S4 is not required to change its taxable year because its March 31 taxable year is allowed pursuant to Rev. Proc. 87-32. Therefore, the remaining shareholders of S4 owning 49 percent of the stock are not permitted the 4-year spread of the items of income and expense with respect to the short year, even if they are required to include their share of S4's items of income and expense from more than one taxable year in one of their years.

Example (9). Assume that C and D are individuals with a taxable year ending June 30. Each owns 50 percent of the stock of corporation S5, an S corporation. S5 has a taxable year ending March 31. S5 cannot establish a business purpose in order to retain a taxable year ending March 31, and thus S5 must change to either a calendar year or a June 30 taxable year (the taxable year of more than 50 percent of its shareholders). Assume that S5 changes to a June 30 taxable year. Furthermore, assume that C's share of S5's income items exceeds C's share of S5's expense items for S5's short taxable year ending June 30, 1987. Unless C elects out of the four-year spread, C's taxable year ending June 30, 1987, is the first of the four taxable years in which C must take into account its share of the items of income and expense resulting from S5's short taxable year ending June 30, 1987.

Example (10). Assume that I, an individual who reports income on the basis of the calendar year, is a shareholder in two S corporations, S6 and S7. Both S corporations have a taxable year ending September 30. Neither S corporation can establish a business purpose for retaining its taxable year. Consequently, each S corporation will change its taxable year to December 31, for the taxable year beginning October 1, 1987. The election to avoid a 4-year spread is made at the shareholder level; in addition, a shareholder may make such elections on an S corporation-by-S corporation basis. Thus, assuming I is eligible to obtain the 4-year spread with respect to income and expense items from S corporations S6 and S7, I may use the 4-year spread with respect to items from S6, while not using the 4-year spread with respect to items from S7.

Example (11). Corporation S8 elected subchapter S status for its taxable year beginning July 1, 1986 and had a short taxable year for the period July 1 through December 31, 1986. S8's shareholders use a calendar year. The shareholders of S8 are not entitled to a 4-year spread with respect to S8's short taxable year ended December 31, 1986, because (a) S8 was not required to change its taxable year for the first taxable year beginning after December 31, 1986, and (b) S8's shareholders did not have items from more than one taxable year of S8 included in their 1986 taxable year.

Example (12). The facts are the same as in example (12), except S8 elected subchapter S status for its taxable year beginning July 1, 1987 and will have a short taxable year for the period July 1 to December 31, 1987. The shareholders of S8 are not entitled to a 4-year spread with respect to S8's short taxable year ended December 31, 1987, because (a) S8's shareholders did not have items from more than one taxable year of S8 included in their 1987 return, and (b) S8 was not an S corporation for a taxable year beginning in 1986.

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason it is impracticable to issue the Treasury decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approval December 16, 1987.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 18, 1987, 3:21 p.m., and published in the issue of the Federal Register for December 23, 1987, 52 F.R. 48524)

Section 444.—Election of Taxable Year Other Than Required Taxable Year

26 CFR 1.444-1T: Election to use a taxable year other than the required taxable year (temporary).

T.D. 8205

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER A, SUBCHAPTER H, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Election of Taxable Year Other Than Required Year by Partnerships, S Corporations and Personal Service Corporations

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the election by partnerships, S corporations, and personal service corporations to use a taxable year other than their required taxable year. In addition, the text of the temporary regulations set forth in this document serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in *** [LR-53-88, page 935, this Bulletin]. Changes to the applicable law were made by the Revenue Act of 1987. The regulations affect partnerships, S corporations, and personal service corporations (and owners of those entities) and provide them with the guidance needed to comply with the law. In addition, the temporary regulations include conforming and clarifying rules regarding the determination of the taxable year of a partnership under section 706.

EFFECTIVE DATE: The temporary regulations are generally effective for taxable years beginning after December 31, 1986.

SUPPLEMENTARY INFORMATION:

BACKGROUND

Sections 706(b), 1378, and 441(i) of the Internal Revenue Code (the Code), as amended by section 806 of the Tax Reform Act of 1986 (the 1986 Act) (Pub. L. 99-514, 100 Stat. 2085)[1986-3 (Vol.1) C.B. 1, 279], generally require partnerships, S corporations, and personal service corporations ("PSCs"), respectively, to conform their taxable years to the taxable years of their owners.

The Revenue Act of 1987 (the 1987 Act) (Pub. L. 100-203, 101 Stat. 1330), enacted on December 22, 1987, added sections 44, 7519, and 280H to the Code, effective for taxable years beginning after December 31, 1986. Section 444 allows certain partnerships, S corporations, and PSCs to make an election (a "section 444 election") to use a taxable year that is different from the taxable year that such entities would otherwise be required to use. Section 444(d)(3), however, generally prohibits entities that are members of a tiered structure from making a section 444 election.

Electing partnerships and S corporations are required to make payments under section 7519 ("required payments") to the Federal government that are intended to represent the value of the tax deferral obtained by the owners of those entities through the entity's use of a taxable year different from the required taxable year.

Electing PSCs failing to distribute certain amounts to employee-owners by December 31 of a taxable year may be required, under section 280H, to defer certain deductions for amounts includible (at any time) in the gross income of employee-owners.

On January 15, 1988, the Internal Revenue Service issued Notice 88-10 (page 478, this Bulletin) to provide guidance with respect to certain issues of immediate concern to taxpayers affected by section 444. Notice 88-10 stated that forthcoming temporary regulations would provide that a section 444 election shall not be required to be made before the later of (i) April 30, 1988, or (ii) 60 days after the publication of those temporary regulations in the Federal Register. Publication of these temporary regulations in the Federal Register commences the beginning of the 60-day period for making a section 444 election. Thus, a section 444 election for the first taxable year beginning after December 31, 1986, must be made on or before July 26, 1988.

On March 11, 1988, the Internal Revenue Service issued Announcement 88-49 (1988-13 I.R.B. 34) to provide guidance to corporations electing S status that are considering whether to make a section 444 election. On March 15, 1988, the Internal Revenue Service issued Notice 88-36 (page 517, this Bulletin) to provide guidance regarding the definition of a "tiered structure" for purposes of section 444(d)(3).

Furthermore, on April 4, 1988, the Internal Revenue Service issued Notice 88-49 (page 532, this Bulletin). Notice 88-49 waived certain penalties and answered additional questions regarding sections 444, 6519, and 280H that had not been answered in the earlier notices related to these sections.

SECTION 444

a. In general.

If three conditions are met, a partnership, S corporation, or PSC is eligible to make a section 444 election. First, with one limited exception, the entity may not be a member of a tiered structure. Second, the entity must not have had a section 444 election in effect previously. Third, certain restrictions on the deferral period of the taxable year to be elected must be satisfied. In general, the deferral period of the taxable year to be elected must be no more than three months. However, there are special rules regarding the deferral period for entities that are changing or retaining their taxable year.

For purposes of section 444 and these temporary regulations, the term "required taxable year" is defined as the taxable year that is determined under section 706(b), 1378, or 441(i), without taking into account any taxable year which is allowable by reason of business purpose. Thus, the calendar year is the required taxable year for most partnerships and all S corporations and PSCs. The only partnerships that can have a required taxable year of other than a calendar year are certain partnerships with fiscal year partners.

Furthermore, for purposes of section 444 and these temporary regulations, the term "deferral period" is defined as the number of months that occur after the end of the taxable year desired under section 444 and through the close of the required taxable year. For example, if the taxable year desired under section 444 is September 30 and the required taxable year is December 31, the deferral period for such September 30 taxable year is 3 months (September 30 to December 31). With respect to taxpayers using a taxable year that is the same as their required taxable year, the deferral period for such year is zero.

If an entity qualifies to make a section 444 election and desires to make such election, the entity must file Form 8716 in accordance with §1.444-3T of these temporary regulations. Furthermore, the entity must comply with the requirements of section 7519 or 280H, whichever is applicable.

A section 444 election shall remain in effect until it is terminated. Paragraph (a)(5) of §1.444-1T of these temporary regulations provides that a section 444 election is terminated when the entity (1) changes to the required taxable year, (2) liquidates (including a deemed liquidation of a partnership pursuant to §1.708-1(b)(1)(iv)), (3) willfully fails to comply with the requirements of section 7519 or 280H, whichever is applicable, or (4) becomes a member of a tiered structure (unless the "same taxable year exception" provided in §1.444-2T(e) of these temporary regulations applies). In addition, a section 444 election is generally terminated if (5) a corporation's S election is terminated or (6) a PSC ceases to be a PSC. However, if a corporation is a PSC immediately after termination of its S election, a section 444 election may be continued by the PSC (subject to the rules of §1.280H-1T). Furthermore, a PSC that ceases to be a PSC solely because it becomes an S corporation may also continue a section 444 election (subject to the rules of §§1.7519-1T and 1.7519-2T).

b. Tiered structure.

1. *In general.*

If an entity is a member of a tiered structure, such entity cannot make or continue a section 444 election unless the same taxable year exception provided in §1.444-2T(e) applies. An entity is generally considered a member of a tiered structure if the entity directly owns any portion of a deferral entity or a deferral entity owns any portion of the entity. A deferral entity is any entity that is a partnership, S corporation, PSC, or trust. However, grantor trusts and certain trusts treated like grantor trusts are excluded from the definition of a deferral entity. Furthermore, as provided in §1.444-2T(c) of these temporary regulations, certain deferral entities may be disregarded if, in the aggregate, they are de minimis with respect to the entity desiring to make a section 444 election.

These temporary regulations provide that the date for determining the existence of a tiered structure is generally the last day of the required taxable year ending within the taxable year that would result from a section 444 election. Thus, for example, assume an S corporation that historically used a September 30 taxable year desires to retain its September 30 taxable year by making a section 444 election for its taxable year beginning October 1, 1987. The general rule provides that December 31, 1987, is the time for determining whether such S corporation is a member of a tiered structure. However, for taxable years beginning in 1987, these temporary regulations provide that an entity will not be a member of a tiered structure if, on the date the entity files its section 444 election for such taxable year, the entity is not a member of a tiered structure. Thus, in the above example, the S corporation will be considered to be a member of a tiered structure for its taxable year beginning October 1, 1987, only if the S corporation is a member of a tiered structure on both December 31, 1987, and the date the S corporation files its section 444 election for such year.

2. *De minimis rules.*

These temporary regulations include two de minimis rules that allow an entity to disregard certain deferral entities in determining whether the entity is a member of a tiered structure. The "downstream de minimis rule" provides that if an entity owns any portion of one or more deferral entities, such ownership is disregarded if, in the aggregate, all such deferral entities meet either (i) the 5 percent adjusted taxable income test, or (ii) the 2 percent gross income test. See §1.444-2T(c)(2) of these temporary regulations for further details on these two tests. The "upstream de minimis rule" provides that if an entity is directly owned by one or more deferral entities, such ownership is disregarded if deferral entities directly own, in the aggregate, 5 percent or less of the entity desiring to make or continue a section 444 election.

3. *Same taxable year exception.*

Paragraph (e) of §1.444-2T of these temporary regulations provides that if a partnership or S corporation is a member of a tiered structure, the partnership or S corporation may have a section 444 election in effect if the tiered structure consists entirely of partnerships or S corporations (or both), all of which have the same taxable year. The same taxable year exception is generally not available if a PSC is a member of the tiered structure. The temporary regulations provide detailed rules for the interaction of the de minimis rules with the same taxable year exception (see §1.444-2T(e)(5)).

4. *Notice 88-36.*

Except for three minor clarifications and several minor editorial changes, §1.444-2T of these temporary regulations contains the same tiered structure rules first provided in Notice 88-36. The first clarification relates to the date for determining the existence of a tiered structure (see §1.444-2T(d)). Specifically, these temporary regulations clarify that if the taxable year resulting from a section 444 election does not include the last day of the required taxable year for such taxable year, then the entity making the section 444 election is not considered to be a member of a tiered structure for such year (see example (2) in §1.444-2T(d)(1)).

The second clarification relates to the exception from the term "deferral entity" for grantor trusts (and certain trusts treated as grantor trusts) in §1.444-2T(b)(2)(ii). Specifically, these temporary regulations clarify that to the extent any taxpayer owns a grantor trust, such taxpayer is treated as directly owning the assets of such a trust. For illustrations of this rule, see examples (1) and (2) in §1.444-2T(b)(2)(ii).

The third clarification is that an affiliated group of personal service corporations filing a consolidated income tax return is treated as a single entity for purposes of determining whether a taxpayer is part of a tiered structure. See §1.444-2T(b)(2)(i).

c. Limitations on deferral period.

In general, a section 444 election may be made only if the deferral period of the taxable year to be elected is not longer than three months. However, if an entity is changing its taxable year, the deferral period of the taxable year to be elected may not be longer than the shorter of (1) three months or (2) the deferral period of the taxable year that is being changed. These temporary regulations define the phrase "deferral period of the taxable year that is being changed" as the deferral period of the taxable year immediately preceding the taxable year for which the entity desires to make a section 444 election.

Thus, for example, assume a partnership that has historically used a March 31 taxable year desires to change to a taxable year ending September 30 for its taxable year beginning April 1, 1987. Further assume that for the taxable year beginning April 1, 1987, the partnership's required taxable year is December 31. Based on these facts, the deferral period of the taxable year being changed is nine months (March 31 to December 31) and the deferral period of the taxable year being elected is three months (September 30 to December 31). As a result, the partnership may, if otherwise qualified (*i.e.*, the partnership is not considered to be a member of a tiered structure), make a section 444 election to change to a year ending September 30 for its taxable year beginning April 1, 1987.

These temporary regulations provide special transitional rules for certain taxpayers. First, §1.444-1T(b)(2)(ii) of these temporary regulations provides that if a corporation (1) elected S status after September 18, 1986, and before January 1, 1988, and (2) elected to have a calendar taxable year, then such corporation is allowed to modify the normal deferral period limitations on changing its taxable year. Specifically, such corporation may substitute the deferral period of the last taxable year prior to electing to be an S corporation for the deferral period of the taxable year that is being changed. Thus, in order to benefit from this special rule, the corporation electing S status must have been in existence prior to electing S status.

The second special transitional rule provides that an entity may, if otherwise qualified, make a section 444 election for its first taxable year beginning after December 31, 1986, to have a taxable year that is the same as the entity's last taxable year beginning in 1986. See §1.444-1T(b)(3) of these temporary regulations.

d. Procedures for making a section 444 election (§1.444-3T).

1. *In general.*

A section 444 election is made by filing Form 8716, "Election to Have a Tax Year Other Than a Required Tax Year," with the Service Center indicated by the instructions to Form 8716. In general, Form 8716 must be filed by the earlier of (i) the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective, or (ii) the due date (without regard to extensions) of the income tax return resulting from the section 444 election. However, if, based on the general rule set forth in the preceding sentence, the due date for filing Form 8716 is prior to July 26, 1988, the due date is extended to July 26, 1988. In addition to filing Form 8716 with the appropriate Service Center, a copy of Form 8716 must be attached to the entity's income tax return for the taxable year for which the section 444 election is made.

2. *Corporations electing S status.*

A corporation electing S status is subject to the same procedural rules for filing Form 8716 as any other entity making a section 444 election. Thus, a corporation electing S status that desires to make a section 444 election is required to file Form 8716 in accordance with the rules in these temporary regulations, but is not required to file Form 8716 with its Form 2553, "Election by a Small Business Corporation." However, a corporation electing S status after September 26, 1988, that desires to make a section 444 election, is required to state on Form 2553 its intention to (i) make a section 444 election, if qualified, or (ii) make a "back-up section 444 election." If a corporation electing S status fails to state either of the above intentions, the District Director may, at his discretion, disregard a subsequent section 444 election for such entity.

Section 1.444-1T(a)(6) provides rules for reactivating certain S elections with respect to the first taxable year of the taxpayer beginning after December 31, 1986.

e. Back-up section 444 election.

These temporary regulations provide that if an entity requests permission, based on business purpose, to use a particular taxable year, such entity may, if otherwise qualified, file a back-up section 444 election. Thus, if the entity's business purpose request is subsequently denied by the Commissioner, the entity shall activate the back-up election for such year. The rules and procedures concerning back-up section 444 elections are provided in §1.444-3T(b)(4) of these temporary regulations.

f. Miscellaneous administrative relief.

These temporary regulations automatically extend the due dates for filing certain income tax returns (see §1.444-3T(c)(1)). These temporary regulations also waive certain late payment penalties that may otherwise be imposed on a PSC or S corporation (see §1.444-3T(c)(2)).

Section III. B. of Notice 88-49 waived certain late payment and filing penalties that may otherwise be imposed on the owners of a partnership or S corporation considering whether to make a section 444 election for its first taxable year beginning after December 31, 1986. However, section III. C. of Notice 88-49 requires that interest must be paid on any underpayment of income tax.

SECTION 7519

a. In general.

Section 7519 and the temporary regulations thereunder apply to any taxable year that a partnership or S corporation has a section 444 election in effect (an "applicable election year"). For each applicable election year, a partnership or S corporation must file a return and make a required payment as provided in §1.7519-2T. However, if the required payment for an applicable election year is not more than $500 and the partnership or S corporation has not been required to make a required payment for a prior year, the partnership or S corporation should not make a required payment for that applicable election year. Nevertheless, such partnership or S corporation must file a return.

b. Required payment.

1. *In general.*

Section 1.7519-1T(a)(3) provides that the term "required payment" means, with respect to any applicable election year of a partnership or S corporation, an amount equal to the excess of—

(i) The product of the applicable percentage of the adjusted highest section 1 rate, multiplied by the net base year income of the entity, over

(ii) the cumulative amount of the required payments actually made for all preceding applicable election years (reduced by the cumulative amount of payments refunded under section 7519(c) for all such preceding years).

Under the temporary regulations, a partnership or S corporation that has made a section 444 election and that is a member of a tiered structure must separately determine the amount of its required payment without regard to the required payment of any other member of the tiered structure. (See example (3) of §1.7519-1T(d)).

2. *Applicable percentage.*

Under section 806(e)(2)(C) of the 1986 Act, certain partners and shareholders are entitled to a four-year "spread" of the income and expense items from a partnership or S corporation that is required to change its taxable year under the 1986 Act. In order to provide a de facto four-year spread, section 7519(b)(1)(A) multiplies the required payment otherwise required to be made by a partnership or S corporation by the applicable percentage defined in section 7519(d)(4). However, certain entities (*e.g.*, a corporation that elected to be an S corporation for a taxable year beginning in 1987) that qualify to make a section 444 election, and thereby obtain the de facto four-year spread, may have partners or shareholders that would not have been entitled to the four-year spread under section 806(e)(2)(C) of the 1986 Act. Nevertheless, the temporary regulations provide that the applicable percentage for the first taxable year beginning in 1987 of any partnership or S corporation properly making a section 444 election is 25 percent.

3. *Adjusted highest section 1 rate.*

For any applicable election year, the term "adjusted highest section 1 rate" means the highest rate of tax under section 1 applicable to the period defined in the regulations, plus 1 percentage point. Notwithstanding the preceding sentence, the adjusted highest section 1 rate is 36 percent for applicable election years beginning in 1987. The temporary regulations provide that for purposes of section 7519 the highest rate of tax is determined without regard to the effect of section 1(g) (relating to the phaseout of the 15-percent rate and personal exemptions).

4. *Net base year income.*

In general, the net base year income of a partnership or S corporation is the sum of—

(i) The deferral ratio multiplied by the partnership's or S corporation's net income for the base year, plus

(ii) The excess (if any) of—

(A) The deferral ratio multiplied by the aggregate amount of applicable payments made by the partnership or S corporation during the base year, over

(B) The aggregate amount of such applicable payments made during the deferral period of the base year.

For purposes of section 7519 and the temporary regulations, the term "base year" means, with respect to any applicable election year, the taxable year of the partnership or S corporation immediately preceding such applicable election year. The temporary regulations define the term "deferral ratio" as the number of months in the deferral period of the applicable election year divided by 12 months.

5. *Applicable payment.*

For purposes of section 7519, the temporary regulations generally define the term "applicable payment" as any amount deductible in the base year that is includible at any time, directly or indirectly, in the gross income of a taxpayer that during the base year is a partner or shareholder. The temporary regulations provide that the term "applicable payment" does not include any guaranteed payments under section 707(c).

In general, an amount is indirectly includible in the gross income of a partner or shareholder if the amount is includible in the gross income of a related party, as determined under §1.7519-1T(b)(5)(iv)(D) of the temporary regulations.

The temporary regulations further provide that if an S corporation was a C corporation for the base year, the corporation shall be treated as if it were an S corporation for the base year for purposes of determining the corporation's net base year income, including applicable payments. Thus, amounts deductible by a C corporation in the base year that are includible at any time in the gross income of a taxpayer that is a shareholder during the base year are treated as if deductible by an S corporation and are, therefore, within the meaning of the term "applicable payment."

6. *Special rule for base year of less than twelve months.*

If a base year is a taxable year of less than twelve months (a "short base year"), the temporary regulations provide special rules for computing the net base year income for such short year. The net base year income for the short base year is an amount equal to the excess, if any, of—

(i) The deferral ratio multiplied by the annualized short base year income, over

(ii) Applicable payments made during the deferral period of the applicable election year following the base year.

See §1.7519-1T(b)(5)(v) of these temporary regulations.

c. Special rules for certain applicable election years.

The temporary regulations provide special rules for determining the applicable payment for certain applicable election years. If an applicable election year is a partnership's or S corporation's first year in existence (*i.e.*, the partnership or S corporation is newly formed and therefore does not have a base year), the temporary regulations provide that the required payment for such applicable election year is zero. If a partnership or S corporation makes a section 444 election and the resulting applicable election year (the "first applicable election year") of the partnership or S corporation ends prior to the last day of the required year, the temporary regulations provide that the required payment for the first applicable election year is zero.

d. Refunds of required payments.

A partnership or S corporation is entitled to make a claim for refund if (1) the product of the applicable percentage of the adjusted highest section 1 rate multiplied by the net base year income is less than the cumulative amount of required payments in all preceding applicable election years (reduced by the cumulative amount of refunds for such preceding years), or (2) the partnership or S corporation terminates its section 444 election as defined in paragraph (a)(5) of §1.444-1T

e. Returns under section 7519.

Section 7519(e)(3) provides that each partnership or S corporation that makes a section 444 election shall include on any required return or statement such information as the Secretary shall prescribe as is necessary to carry out the provisions of section 7519. The temporary regulations provide that with respect to an applicable election year, a partnership or S corporation must file a return showing the required payment, even if the required payment for the applicable election year is zero. For an applicable election year beginning in 1987, the return shall be made on Form 720, "Quarterly Federal Excise Tax Return." For an applicable election year beginning after 1987, the return shall also be made on Form 720 unless another form is prescribed by the Commissioner.

Partnerships and S corporations that would otherwise file Form 720 for the second quarter of 1988 must file Form 720 by the normal due date of such form for the second quarter of 1988. Thus, in most cases, these partnerships and S corporations will file Form 720 on or before July 31, 1988. However, some partnerships and S corporations (for example, those required to pay the windfall profits tax) must file Form 720 on or before August 31, 1988. See the instructions to Form 720 for additional general information. Partnerships and S corporations making a section 444 election that would not otherwise file Form 720 for the second quarter of 1988 must file Form 720 on or before July 31, 1988. See §1.444-3T(b)(4)(iii) for a special rule that may extend the due date for filing a return when a partnership or S corporation makes a back-up section 444 election.

f. Payment of required payments.

For an applicable election year beginning in 1987, the required payment is due and payable without assessment and notice on or before the date specified in the temporary regulations for filing the Form 720. The required payment must be paid by check or money order and such check or money order must be sent, together with Form 720, to the Service Center indicated by the instructions to Form 720. See §1.444-3T(b)(4)(iii) for a special rule that may extend the due date for making a required payment when a partnership or S corporation makes a back-up section 444 election.

For an applicable election year beginning after 1987, the required payment is due and payable without assessment and notice on or before May 15 of the calendar year following the calendar year in which the applicable election year begins.

SECTION 280H

a. In general.

Section 280H applies to any taxable year that a personal service corporation (PSC) has a section 444 election in effect (an "applicable election year"). For purposes of section 280H, the term "personal service corporation" has the same meaning given such term in §1.441-4T(d).

If, for any applicable election year, a PSC does not satisfy the minimum distribution requirement of section 280H(c), the deduction otherwise allowable under chapter 1 of the Code for applicable amounts shall not exceed the maximum deductible amount. Any amount not allowed as a deduction in an applicable election year is allowed as a deduction in the succeeding taxable year.

Section 280H provides that the disallowance of deductions under section 280H shall not apply for purposes of subchapter G of chapter 1 of the Code (relating to personal holding companies). The temporary regulations clarify that the disallowance of deductions under section 280H does not apply for purposes of determining whether compensation to employee-owners is reasonable.

b. Applicable amount.

For purposes of section 280H, the term "applicable amount" means, with respect to a taxable year, any amount that is otherwise deductible by a PSC in such year and includible at any time, directly or indirectly, in the gross income of employee-owners. The temporary regulations clarify that an amount includible in the gross income of an employee-owner will be considered an applicable amount even though such employee owns no stock of the corporation on the date the employee included the amount in income.

In general, an amount is indirectly includible in the gross income of an employee-owner if the amount is includible in the gross income of a related party, as determined under §1.280H-1T(b)(4)(ii) of the temporary regulations.

c. Minimum distribution requirement.

A PSC meets the minimum distribution requirement for an applicable election year if, during the deferral period of such year, applicable amounts (not including excess applicable amounts carried over from the preceding year) for all employee-owners in the aggregate equal or exceed the lesser of the amount determined under the "preceding year test" or the amount determined under the "3-year average test" as described in paragraph (c) of §1.280H-1T.

The temporary regulations provide special rules for applying section 280H to newly organized personal service corporations and to existing corporations that become PSCs. A newly organized PSC is deemed to satisfy the preceding year test and the 3-year average test for the first year of the corporation's existence. If an existing corporation was not a PSC for each of the three years preceding the corporation's first applicable election year, the determination of whether the corporation satisfies the preceding year test and the three-year average test is made by treating the corporation as though it were a PSC for each of the three preceding years (or as many years as the corporation has been in existence).

d. Preceding year test.

The amount determined under the preceding year test is the product of (1) the applicable amounts during the taxable year preceding the applicable election year (the "preceding taxable year"), divided by the number of months in the preceding taxable year, multiplied by (2) the number of months in the deferral period of the preceding taxable year.

e. 3-year average test.

The amount determined under the 3-year average test is the applicable percentage multiplied by the adjusted taxable income for the deferral period of the applicable election year. The term "applicable percentage" means the percentage (not in excess of 95 percent) determined by dividing—

(1) The applicable amounts during the 3 taxable years of the corporation immediately preceding the applicable election year, by

(2) The adjusted taxable income of such corporation for such 3 taxable years.

The temporary regulations provide that if the PSC has been in existence less than 3 years, the 3-year average test is applied taking into account the years the corporation has been in existence.

f. Adjusted taxable income.

The temporary regulations define the term "adjusted taxable income" as taxable income determined without regard to applicable amounts. The temporary regulations provide that the adjusted taxable income for the deferral period of the applicable election year equals the adjusted taxable income that would result if the PSC filed an income tax return for the deferral period of the applicable election year under its normal methods of accounting. However, under the temporary regulations, a PSC may make a reasonable estimate of such amount.

For purposes of determining the adjusted taxable income for any period, the temporary regulations provide that any NOL carryover shall be reduced by the amount of such carryover that is attributable to the deduction of applicable amounts. The portion of the NOL carryover attributable to the deduction of applicable amounts is the difference between the NOL carryover computed with the deduction of such amounts and the NOL carryover computed without the deduction of such amounts. For purposes of determining the adjusted taxable income for the deferral period, an NOL carryover to the applicable election year, as reduced, shall be allowed first against the income of the deferral period.

g. Maximum deductible amount.

The term "maximum deductible amount" means the applicable amounts during the deferral period of the applicable election year, plus the product of (1) such applicable amounts divided by the number of months in the deferral period of the applicable election year, multiplied by (2) the number of months in the nondeferral period of the applicable election year. The term "nondeferral period" means the portion of the applicable election year that occurs after the portion of such year constituting the deferral period.

h. NOL carrybacks disallowed.

No net operating loss carryback is allowed to (or from) any taxable year of a PSC to which a section 444 election applies.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The collection of information requirements contained in this regulation have been submitted to the Office of Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduction Act of 1980. These requirements have been approved by OMB under control number 1545-1036.

* * * * *

Adoption of amendments to the regulations

For the reasons set forth in the preamble, Parts 1 and 602 of Title 26, Code of Federal Regulations, are amended as set forth below:

INCOME TAX REGULATIONS
(26 CFR Part 1)

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. *** Sections 1.444-0T through 1.444-3T and section 1.706-3T are also issued under 26 U.S.C. 444(f). Sections 1.7519-0T through 1.7519-3T, and 1.280H-0T and 1.280H-1T also issued under 26 U.S.C. 7519(g).

Par. 2. Sections 1.444-0T through 1.444-3T are added in the appropriate place.

§1.444-0T Table of contents (temporary).

This section lists the captions that appear in the temporary regulations under section 444.

§1.444-1T Election to use a taxable year other than the required taxable year (temporary).

(a) General rules.
  (1) Year other than required year.
  (2) Effect of section 444 election.
    (i) In general.
    (ii) Duration of section 444 election.
  (3) Section 444 election not required for certain years.
  (4) Required taxable year.
  (5) Termination of section 444 election.
    (i) In general.
    (ii) Effective date of termination.
    (iii) Example.
    (iv) Special rule for entity that liquidates or is sold prior to making a section 444 election, required return, or required payment.
  (6) Re-activating certain S elections.
    (i) Certain corporations electing S status that did not make a back-up calendar year request.
    (ii) Certain corporations that revoked their S status.
    (iii) Procedures for re-activating an S election.
    (iv) Examples.
(b) Limitation on taxable years that may be elected.
  (1) General rule.
  (2) Changes in taxable year.
    (i) In general.
    (ii) Special rule for certain existingcorporationselecting S status.
    (iii) Deferral period of the taxable year that is being changed.
    (iv) Examples.
  (3) Special rule for entities retaining 1986 taxable year.
  (4) Deferral period.
    (i) Retentions of taxable year.
    (ii) Adoptions of and changes in taxable year.
      (A) In general.
      (B) Special rule.
      (C) Examples.
  (5) Miscellaneous rules.
    (i) Special rule for determining the taxable year of a corporation electing S status.
    (ii) Special procedure for cases where an income

- tax return is superseded.
  - (A) In general.
  - (B) Procedure for superseding return.
- (iii) Anti-abuse rule.
- (iv) Special rules for partial months and 52-53-week taxable years.
- (c) Effective date.
- (d) Examples.
  - (1) Changes in taxable year.
  - (2) Special rule for entities retaining their 1986 taxable year.

§1.444-2T Tiered structure (temporary).

- (a) General rule.
- (b) Definition of a member of a tiered structure.
  - (1) In general.
  - (2) Deferral entity.
    - (i) In general.
    - (ii) Grantor trusts.
  - (3) Anti-abuse rule.
- (c) De minimis rules.
  - (1) In general.
  - (2) Downstream de minimis rule.
    - (i) General rule.
    - (ii) Definition of testing period.
    - (iii) Definition of adjusted taxable income.
      - (A) Partnership.
      - (B) S corporation.
      - (C) Personal service corporation.
    - (iv) Special rules.
      - (A) Pro-forma rule.
      - (B) Reasonable estimates allowed.
      - (C) Newly formed entities.
        - (*1*) Newly formed deferral entities.
        - (*2*) Newly formed partnership, S corporation, or personal service corporation desiring to make a section 444 election.
  - (3) Upstream de minimis rule.
- (d) Date for determining the existence of a tiered structure.
  - (1) General rule.
  - (2) Special rule for taxable years beginning in 1987.
- (e) Same taxable year exception.
  - (1) In general.
  - (2) Definition of tiered structure.
    - (i) General rule.
    - (ii) Special flow-through rule for downstream controlled partnerships.
  - (3) Determining the taxable year of a partnership or S corporation.
  - (4) Special rule for 52-53-week taxable years.
  - (5) Interaction with de minimis rules.
    - (i) Downstream de minimis rule.
      - (A) In general.
      - (B) Special rule for members of a tiered structure directly owned by a downstream controlled partnership.
    - (ii) Upstream de minimis rule.
- (f) Examples.
- (g) Effective date.

§1.444-3T Manner and time of making section 444 election (temporary).

- (a) In general.
- (b) Manner and time of making election.
  - (1) General rule.
  - (2) Special extension of time for making an election.
  - (3) Corporation electing to be an S corporation.
    - (i) In general.
    - (ii) Examples.
  - (4) Back-up section 444 election.
    - (i) General rule.
    - (ii) Procedures for making a back-up section 444 election.
    - (iii) Procedures for activating a back-up section 444 election.
      - (A) Partnerships and S corporations.
        - (*1*) In general.
        - (*2*) Special rule if Form 720 used to satisfy return requirement.
      - (B) Personal service corporations.
    - (iv) Examples.
- (c) Administrative relief.
  - (1) Extension of time to file income tax returns.
    - (i) Automatic extension.
    - (ii) Additional extensions.
    - (iii) Examples.
  - (2) No penalty for certain late payments.
    - (i) In general.
    - (ii) Example.
- (d) Effective date.

§1.444-1T Election to use a taxable year other than the required taxable year (temporary).

(a) *General rules*—(1) *Year other than required year.* Except as otherwise provided in this section and §1.444-2T, a partnership, S corporation, or personal service corporation (as defined in §1.441-4T(d)) may make or continue an election (a "section 444 election") to have a taxable year other than its required taxable year. See paragraph (b) of this section for limitations on the taxable year that may be elected. See §1.444-2T for rules that generally prohibit a partnership, S corporation, or personal service corporation that is a member of a tiered structure from making or continuing a section 444 election. See §1.444-3T for rules explaining how and when to make a section 444 election.

(2) *Effect of section 444 election*—(i) *In general.* A partnership or S corporation that makes or continues a section 444 election shall file returns and make payments as required by §§1.7519-1T and 1.7519-2T. A personal service corporation that makes or continues a section 444 election is subject to the deduction limitation of §1.280H-1T.

(ii) *Duration of section 444 election.* A section 444 election shall remain in effect until the election is terminated pursuant to paragraph (a)(5) of this section.

(3) *Section 444 election not required for certain years.* A partnership, S corporation, or personal service corporation is not required to make a section 444 election to use—

(i) A taxable year for which such entity establishes a business purpose to the satisfaction of the Commissioner (*i.e.*, approved under section 4 or 6 of Rev. Proc. 87-32, 1987-2 C.B. 396, or any successor revenue ruling or revenue procedure), or

(ii) A taxable year that is a "grandfathered fiscal year," within the meaning of section 5.01(2) of Rev. Proc. 87-32 or any successor revenue ruling or revenue procedure.

Although a partnership, S corporation or personal service corporation qualifies to use a taxable year described in paragraph (a)(3)(i) or (ii) of this section, such entity may, if otherwise qualified, make a section 444 election to use a different taxable year. Thus, for example, assume that a personal service corporation that historically used a January 31 taxable year established to the satisfaction of the Commissioner, under section 6 of Rev. Proc. 87-32, a business purpose to use a September 30 taxable year for its taxable year beginning February 1, 1987. Pursuant to this paragraph (a)(3), such personal service corporation may use a September 30 taxable year without making a section 444 election. However, the corporation may, if otherwise qualified, make a section 444 election to use a year ending other than September 30 for its taxable year beginning February 1, 1987.

(4) *Required taxable year.* For purposes of this section, the term "required taxable year" means the taxable year determined under section 706(b), 1378, or 441(i) without taking into account any taxable year which is allowable either—

(i) By reason of business purpose (*i.e.*, approved under section 4 or 6 of Rev. Proc. 87-32 or any successor revenue ruling or procedure), or

(ii) As a "grandfathered fiscal year" within the meaning of section 5.01(2) of Rev. Proc. 87-32, or any successor revenue ruling or procedure.

(5) *Termination of section 444 election*—(i) *In general.* A section 444 election is terminated when—

(A) A partnership, S corporation, or personal service corporation changes to its required taxable year; or

(B) A partnership, S corporation, or personal service corporation liquidates (including a deemed liquidation of a partnership under §1.708-1(b)(1)(iv)); or

(C) A partnership, S corporation, or personal service corporation willfully fails to comply with the requirements of section 7519 or 280H, whichever is applicable; or

(D) A partnership, S corporation, or personal service corporation becomes a member of a tiered structure (within the meaning of §1.444-2T), unless it is a partnership or S corporation that meets the same taxable year exception under §1.444-2T(e); or

(E) An S corporation's S election is terminated; or

(F) A personal service corporation ceases to be a personal service corporation.

However, if a personal service corporation, that has a section 444 election in effect, elects to be an S corporation, the S corporation may continue the section 444 election of the personal service corporation. Similarly, if an S corporation that has a section 444 election in effect terminates its S election and immediately becomes a personal service corporation, the personal service corporation may continue the section 444 election of the S corporation. If a section 444 election is terminated under this paragraph (a)(5), the partnership, S corporation, or personal service corporation may not make another section 444 election for any taxable year.

(ii) *Effective date of termination.* A termination of a section 444 election shall be effective—

(A) In the case of a change to the required year, on the first day of the short year caused by the change;

(B) In the case of a liquidating entity, on the date the liquidation is completed for tax purposes;

(C) In the case of willful failure to comply, on the first day of the taxable year (determined as if a section 444 election had never been made) determined in the discretion of the District Director;

(D) In the case of membership in a tiered structure, on the first day of the taxable year in which the entity is considered to be a member of a tiered structure, or such other taxable year determined in the discretion of the District Director;

(E) In the case of termination of S status, on the first day of the taxable year for which S status no longer exists;

(F) In the case of a personal service corporation that changes status, on the first day of the taxable year, for which the entity is no longer a personal service corporation.

In the case of a termination under this paragraph (a)(5) that results in a short taxable year, an income tax return is required for the short period. In order to allow the Service to process the affected income tax return in an efficient manner, a partnership, S corporation, or personal service corporation that files such a short period return should type or legibly print at the top of the first page of the income tax return for the short taxable year—"SECTION 444 ELECTION TERMINATED." In addition, a personal service corporation that changes its taxable year to the required taxable year is required to annualize its income for the short period.

(iii) *Example.* The provisions of paragraph (a)(5)(ii) of this section may be illustrated by the following example.

Example. Assume a partnership that is 100 percent owned, at all times, by calendar year individuals has historically used a June 30 taxable year. Also assume the partnership makes a valid section 444 election to retain a year ending June 30 for its taxable year beginning July 1, 1987. However, for its taxable year beginning July 1, 1988, the partnership changes to a calendar year, its required year. Based on these facts, the partnership's section 444 election is terminated on July 1, 1988, and the partnership must file a short period return for the period July 1, 1988—December 31, 1988. Furthermore, pursuant to §1.702-3T(a)(1), the partners in such partnership are not entitled to a 4-year spread with respect to partnership items of income and expense for the taxable year beginning July 1, 1988 and ending December 31, 1988.

(iv) *Special rule for entity that liquidates or is sold prior to making a section 444 election, required return, or required payment.* A partnership, S corporation, or personal service corporation that is liquidated or sold for tax purposes before a section 444 election, required return, or required payment is made for a particular year may, nevertheless, make or continue a section 444 election, if otherwise qualified. (See §§1.7519-2T(a)(2) and 1.7519-1T(a)(3), respectively, for a description of the required return and a definition of the term "required payment.") However, the partnership, S corporation, or personal service corporation (or a trustee or agent thereof) must comply with the requirements for making or continuing a section 444 election. Thus, if applicable, required payments must be made and a subsequent claim for refund must be made in accordance with §1.7519-2T(a)(6). The following examples illustrate the application of this paragraph (a)(5)(iv).

Example (1). Assume an existing S corporation historically used a June 30 taxable year and desires to make a section 444 election for its taxable year beginning July 1, 1987. Assume further that the S corporation is liquidated for tax purposes on February 15, 1988. If otherwise qualified, the S corporation (or a trustee or agent thereof) may make a section 444 election to have a taxable year beginning July 1, 1987, and ending February 15, 1988. However, if the S corporation makes a section 444 election, it must comply with the requirements for making a section 444 election, including making required payments.

Example (2). The facts are the same as in example (1), except that instead of liquidating on February 15, 1988, the shareholders of the S corporation sell their stock to a corporation on February 15, 1988. Thus, the corporation's S election is terminated on February 15, 1988. If otherwise qualified, the corporation may make a section 444 election to have a taxable year beginning July 1, 1987, and ending February 14, 1988.

Example (3). The facts are the same as in example (2), except that the new shareholders are individuals. Furthermore, the corporation's S election is not terminated. Based on these facts, the S corporation, if otherwise qualified, may make a section 444 election to retain a year ending June 30 for its taxable year beginning July 1, 1987. Furthermore, the S corporation may, if otherwise qualified, continue its section 444 election for subsequent taxable years.

(6) *Re-activating certain S elections*—(i) *Certain corporations electing S status that did not make a back-up calendar year request.* If a corporation that timely filed Form 2553, Election by a Small Business Corporation, effective for its first taxable year beginning in 1987—

(A) Requested a fiscal year based on business purpose,

(B) Did not agree to use a calendar year in the event its business purpose request was denied, and

(C) Such business purpose request is denied or withdrawn, such corporation may retroactively re-activate its S election by making a valid section 444 election for its first taxable year beginning in 1987 and complying with the procedures in paragraph (a)(6)(iii) of this section.

(ii) *Certain corporations that revoked their S status.* If a corporation that used a fiscal year revoked its S election (pursuant to section 1362(d)(1)) for its first taxable year beginning in 1987, such corporation may retroactively re-activate its S election (*i.e.*, rescind its revocation) by making a valid section 444 election for its first taxable year beginning in 1987 and complying with the procedures in paragraph (a)(6)(iii) of this section.

(iii) *Procedures for re-activating an S election.* A corporation re-activating its S election pursuant to paragraph (a)(6)(i) or (ii) of this section must—

(A) Obtain the consents of all shareholders who have owned stock in the corporation since the first day of the first taxable year of the corporation beginning after December 31, 1986,

(B) Include the following statement at the top of the first page of the corporation's Form 1120S for its first taxable year beginning in 1987—"SECTION 444 ELECTION—RE-ACTIVATES S STATUS," and

(C) Include the following statement with Form 1120S—"RE-ACTIVATION CONSENTED TO BY ALL SHAREHOLDERS WHO HAVE OWNED STOCK AT ANY TIME SINCE THE FIRST DAY OF THE FIRST TAXABLE YEAR OF THIS CORPORATION BEGINNING AFTER DECEMBER 31, 1986."

(iv) *Examples.* The provisions of this paragraph (a)(6) may be illustrated by the following examples.

Example (1). Assume a corporation historically used a June 30 taxable year and such corporation timely filed Form 2553, Election by a Small Business Corporation, to be effective for its taxable year beginning July 1, 1987. On its Form 2553, the corporation requested permission to retain its June 30 taxable year based on business purpose. However, the corporation did not agree to use a calendar year in the event its business purpose request was denied. On April 1, 1988, the Internal Revenue Service notified the corporation that its business purpose request was denied and therefore the corporation's S election was not effective. Pursuant to paragraph (a)(6)(i) of this section, the corporation may re-activate its S election by making a valid section 444 election and complying with the procedures in paragraph (a)(6)(iii) of this section.

Example (2). The facts are the same as in example (1), except that as of July 26, 1988, the Internal Revenue Service has not yet determined whether the corporation has a valid business purpose to retain a June 30 taxable year. Based on these facts, the corporation may, if otherwise qualified, make a back-up section 444 election as provided in §1.444-3T(b)(4). If the corporation's business purpose request is subsequently denied, the corporation should follow the procedures in §1.444-3T(b)(4)(iii) for activating a back-up section 444 election rather than the procedures provided in this paragraph (a)(6) for re-activating an S election.

Example (3). Assume a corporation has historically been an S corporation with a March 31 taxable year. However, for its taxable year beginning April 1, 1987, the corporation revoked its S election pursuant to section 1362(d)(1). Pursuant to paragraph (a)(6)(ii) of this section, such corporation may retroactively rescind its S election revocation by making a valid section 444 election for its taxable year beginning April 1, 1987, and complying with the procedures provided in paragraph (a)(6)(iii) of this section. If the corporation retroactively rescinds its S revocation, the corporation shall file a Form 1120S for its taxable year beginning April 1, 1987.

(b) *Limitation on taxable years that may be elected*—(1) *General rule.* Except as provided in paragraphs (b)(2) and (3) of this section, a section 444 election may be made only if the deferral period (as defined in paragraph (b)(4) of this section) of the taxable year to be elected is not longer than three months.

(2) *Changes in taxable year*—(i) *In general.* In the case of a partnership, S corporation, or personal service corporation changing its taxable year, such entity may make a section 444 election only if the deferral period of the taxable year to be elected is not longer than the shorter of—

(A) Three months, or

(B) The deferral period of the taxable year that is being changed, as defined in paragraph (b)(2)(iii) of this section.

(ii) *Special rule for certain existing corporations electing S status.* If a corporation with a taxable year other than the calendar year—

(A) Elected after September 18, 1986, and before January 1, 1988, under section 1362 of the Code to be an S corporation, and

(B) Elected to have the calendar year as the taxable year of the S corporation, then, for taxable years beginning before 1989, paragraph (b)(2)(i) of this section shall be applied by taking into account the deferral period of the last taxable year of the corporation prior to electing to be an S corporation, rather than the deferral period of the taxable year that is being changed. Thus, the provisions of the preceding sentence do not apply to a corporation that elected to be an S corporation for its first taxable year.

(iii) *Deferral period of the taxable year that is being changed.* For purposes of paragraph (b)(2)(i)(B) of this section, the phrase "deferral period of the taxable year that is being changed" means the deferral period of the taxable year immediately preceding the taxable year for which the taxpayer desires to make a section 444 election. Furthermore, the deferral period of such year will be determined by using the required taxable year of the taxable year for which the taxpayer desires to make a section 444 election. For example, assume P, a partnership that has historically used a March 31 taxable year, desires to change to a September 30 taxable year by making a section 444 election for its taxable year beginning April 1, 1987. Furthermore, assume that pursuant to paragraph (a)(4) of this section, P's required taxable year for the taxable year beginning April 1, 1987 is a year ending December 31. Based on these facts, the deferral period of the taxable year being changed is nine months (the period from March 31 to December 31).

(iv) *Examples.* See paragraph (d)(1) of this section for examples that illustrate the provisions of this paragraph (b)(2).

(3) *Special rule for entities retaining 1986 taxable year.* Notwithstanding paragraph (b)(2) of this section, a partnership, S corporation, or personal service corporation may, for its first taxable year beginning after December 31, 1986, if otherwise qualified, make a section 444 election to have a taxable year that is the same as the entity's last taxable year beginning in 1986. See paragraph (d)(2) of this section for examples that illustrate the provisions of this paragraph (b)(3).

(4) *Deferral period*—(i) *Retentions of taxable year.* For a partnership, S corporation, or personal service corporation that desires to retain its taxable year by making a section 444 election, the term "deferral period" means the months between the beginning of such year and the close of the first required taxable year (as defined in paragraph (a)(4) of this section). The following example illustrates the application of this paragraph (b)(4)(i).

Example. AB partnership has historically used a taxable year ending July 31. AB desires to retain its July 31 taxable year by making a section 444 election for its taxable year beginning August 1, 1987. Calendar year individuals, A and B, each own 50 percent of the profits and capital of AB; thus, under paragraph (a)(4) of this section AB's required taxable year is the year ending December 31. Pursuant to this paragraph (b)(4)(i), if AB desires to retain its year ending July 31, the deferral period is five months (the months between July 31 and December 31).

(ii) *Adoptions of and changes in taxable year*—(A) *In general.* For a partnership, S corporation, or personal service corporation that desires to adopt or change its taxable year by making a section 444 election, the term "deferral period" means the months that occur after the end of the taxable year desired under section 444 and before the close of the required taxable year.

(B) *Special rule.* If a partnership, S corporation or personal service corporation is using the required taxable year as its taxable year, the deferral period is deemed to be zero.

(C) *Examples.* The provisions of this paragraph (b)(4)(ii) may be illustrated by the following examples.

Example (1). Assume that CD partnership has historically used the calendar year and that CD's required taxable year is the calendar year. Under the special rule provided in paragraph (b)(4)(ii)(B) of this section, CD's deferral period is zero. See paragraph (b)(2)(i) of this section for rules that preclude CD from making a section 444 election to change its taxable year.

Example (2). E, a newly formed partnership, began operations on December 1, 1987, and is owned by calendar year individuals. E desires to make a section 444 election to adopt a September 30 taxable year. E's required taxable year is December 31. Pursuant to paragraph (b)(4)(ii)(A) of this section, E's deferral period for the taxable year beginning December 1, 1987, is three months (the number of months between September 30 and December 31).

Example (3). Assume that F, a personal service corporation, has historically used a June 30 taxable year. F desires to make a section 444 election to change to an August 31 taxable year, effective for its taxable year beginning July 1, 1987. For purposes of determining the availability of a section 444 election for changing to the taxable year ending August 31, the deferral period of an August 31 taxable year is four months (the number of months between August 31 and December 31). The deferral period for F's existing June 30 taxable year is six months (the number of months between June 30 and December 31). Pursuant to §1.444-1T(b)(2)(i), F may not make a section 444 election to change to an August 31 taxable year.

(5) *Miscellaneous rules*—(i) *Special rule for determining the taxable year of a corporation electing S status.* For purposes of this section, and only for purposes of this section, a corporation that elected to be an S corporation for a taxable year beginning in 1987 or 1988 and which elected to be an S corporation prior to September 26, 1988, will not be considered to have adopted or changed its taxable year by virtue of information included on Form 2553, Election by a Small Business Corporation. See example (8) in paragraph (d) of this section.

(ii) *Special procedure for cases where an income tax return is superseded*—(A) *In general.* In the case of a partnership, S corporation, or personal service corporation that filed an income tax return for its first taxable year beginning after December 31, 1986, but subsequently makes a section 444 election that would result in a different year end for such taxable year, the income tax return filed pursuant to the section 444 election will supersede the original return. However, any payments of income tax made with respect to such superseded return will be credited to the taxpayer's superseding return and the taxpayer may file a claim for refund for such payments. See examples (5) and (7) in paragraph (d)(2) of this section.

(B) *Procedure for superseding return.* In order to allow the Service to process the affected income tax returns in an efficient manner, a partnership, S corporation, or personal service corporation that desires to supersede an income tax return in accordance with paragraph (b)(5)(ii)(A) of this section, should type or legibly print at the top of the first page of the income tax return for the taxable year elected— "SECTION 444 ELECTION—SUPERSEDES PRIOR RETURN."

(iii) *Anti-abuse rule*—If an existing partnership, S corporation or personal service corporation ("predecessor entities"), or the owners thereof, transfer assets to a related party and the principal purpose of such transfer is to—

(A) Create a deferral period greater than the deferral period of the predecessor entity's taxable year, or

(B) Make a section 444 election following the termination of the predecessor entity's section 444 election,

then such transfer will be disregarded for purposes of section 444 and this section, even if the deferral created by such change is effectively eliminated by a required payment (within the meaning of section 7519) or deferral of a deduction (to a personal service corporation under section 280H). The following example illustrates the application of this paragraph (b)(5)(iii).

Example. Assume that P1 is a partnership that historically used the calendar year and is owned by calendar year partners. Assume that P1 desires to make a section 444 election to change to a September year for the taxable year beginning January 1, 1988. P1 may not make a section 444 election to change taxable years under section 444(b)(2) because its current deferral period is zero. Assume further that P1 transfers a substantial portion of its assets to a newly-formed partnership (P2), which is owned by the partners of P1. Absent paragraph (b)(5)(iii) of this section, P2 could, if otherwise qualified, make a section 444 election under paragraph (b)(1) of this section to use a taxable year with a three month or less deferral period (*i.e.*, a September 30, October 31, or November 30 taxable year). However, if the principal purpose of the asset transfer was to create a one-, two-, or three-month deferral period by P2 making a section 444 election, the section 444 election shall not be given effect, even if the deferral would be effectively eliminated by P2 making a required payment under section 7519.

(iv) *Special rules for partial months and 52-53-week taxable years.* Except as otherwise provided in §1.280H-1T(c)(2)(i)(A), for purposes of this section and §§1.7519-1T, 1.7519-2T and 1.280H-1T—

(A) A month of less than 16 days is disregarded, and a month of more than 15 days is treated as a full month; and

(B) A 52-53-week taxable year with reference to the end of a particular month will be considered to be the same as a taxable year ending with reference to the last day of such month.

(c) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

(d) *Examples*—(1) *Changes in taxable year.* The following examples illustrate the provisions of paragraph (b)(2) of this section.

Example (1). A is a personal service corporation that historically used a June 30 taxable year. A desires to make a section 444 election to change to an August 31 taxable year, effective with its taxable year beginning July 1, 1987. Under paragraph (b)(4)(ii) of this section, the deferral period of the taxable year to be elected is four months (the number of months between August 31 and December 31). Furthermore, the deferral period of the taxable year that is being changed is six months (the number of months between June 30 and December 31). Pursuant to paragraph (b)(2)(i) of this section, a taxpayer may, if otherwise qualified, make a section 444 election to change to a taxable year only if the deferral period of the taxable year to be elected is not longer than the shorter of three months or the deferral period of the taxable year being changed. Since the deferral period of the taxable year to be elected (August 31) is greater than three months, A may not make a section 444 election to change to the taxable year ending August 31. However, since the deferral period of the taxable year that is being changed is three months or more, A may, if otherwise qualified, make a section 444 election to change to a year ending September 30, 1987 (three-month deferral period), a year ending October 31, 1987 (two-month deferral period), or a year ending November 30, 1987 (one-month deferral period). In addition, instead of making a section 444 election to change its taxable year, A could, if otherwise qualified, make a section 444 election to retain its June year end, pursuant to paragraph (b)(3) of this section.

Example (2). B, a corporation that historically used an August 31 taxable year, elected on November 1, 1986 to be an S corporation for its taxable year beginning September 1, 1986. As a condition to having the S election accepted, B agreed on Form 2553 to use a calendar year. Pursuant to the general effective date provided in paragraph (c) of this section, B may not make a section 444 election for its taxable year beginning in 1986. Thus, B must file a short period income tax return for the period September 1 to December 31, 1986.

Example (3). The facts are the same as in example (2), except that B desires to make a section 444 election for its taxable year beginning January 1, 1987. Absent paragraph (b)(2)(ii) of this section, B would not be allowed to change its taxable year because the deferral period of the taxable year being changed (*i.e.*, the calendar year) is zero. However, pursuant to the special rule provided in paragraph (b)(2)(ii) of this section, B shall apply paragraph (b)(2)(i) of this section by taking into account the deferral period of the last taxable year of B prior to B's election to be an S corporation (four months), rather than the deferral period of B's taxable year that is being changed (zero months). Thus, if otherwise qualified, B may make a section 444 election to change to a taxable year ending September 30, October 31, or November 30, for its taxable year beginning January 1, 1987.

Example (4). The facts are the same as in example (3), except that B files a calendar year income tax return for 1987 rather than making a section 444 election. However, for its taxable year beginning January 1, 1988, B desires to change its taxable year by making a section 444 election. Given that the special rule provided in paragraph (b)(2)(ii) of this section applies to section 444 elections made in taxable years beginning before 1989, B may, if otherwise qualified, make a section 444 election to change to a taxable year ending September 30, October 31, or November 30 for its taxable year beginning January 1, 1988.

Example (5). C, a corporation that historically used a June 30 taxable year, elected on December 15, 1986 to be an S corporation for its taxable year beginning July 1, 1987. As a condition to having the S election accepted, C agreed on Form 2553 to use a calendar year. Although pursuant to paragraph (b)(3) of this section, C would, if otherwise qualified, be allowed to retain its June 30 taxable year, C desires to change to a September 30 taxable year by making a section 444 election. Pursuant to paragraph (b)(2) of this section, a taxpayer may, if otherwise qualified, make a section 444 election to change to a taxable year only if the deferral period of the taxable year to be elected is not longer than the shorter of three months or the deferral period of the taxable year being changed. Given these facts, the deferral period of the taxable year to be elected is 3 months (September 30 to December 31) while the deferral period of the taxable year being changed is 6 months (June 30 to December 31). Thus, C may, if otherwise qualified, change to a September 30 taxable year for its taxable year beginning July 1, 1987, by making a section 444 election. The fact that C agreed on Form 2553 to use a calendar year is not relevant.

Example (6). D, a corporation that historically used a March 31 taxable year, elects on June 1, 1988 to be an S corporation for its taxable year beginning April 1, 1988. D desires to change to a June 30 taxable year by making a section 444 election for its taxable year beginning April 1, 1988. Pursuant to paragraph (b)(2)(i) of this section, D may not change to a June 30 taxable year because such year would have a deferral period greater than 3 months. However, if otherwise qualified, D may make a section 444 election to change to a taxable year ending September 30, October 31, or November 30 for its taxable year beginning April 1, 1988.

Example (7). E, a corporation that began operations on November 1, 1986, elected to be an S corporation on December 15, 1986, for its taxable year beginning November 1, 1986. E filed a short period income tax return for the period November 1 to December 31, 1986. E desires to change to a September 30 taxable year by making a section 444 election for its taxable year beginning January 1, 1987. Although E elected to be an S corporation after September 18, 1986, and before January 1, 1988, paragraph (b)(2)(ii) of this section does not apply to E since E was not a C corporation prior to electing S status. Thus, E may not change its taxable year for the taxable year beginning January 1, 1987, by making a section 444 election.

Example (8). The facts are the same as in example (7), except that E began operations on April 15, 1987, and elected to be an S corporation on June 1, 1987, for its taxable year beginning April 15, 1987. As a condition to being an S corporation, E agreed on Form 2553 to use a calendar year. E desires to make a section 444 election to use a year ending September 30 for its taxable year beginning April 15, 1987. Pursuant to paragraph (b)(5)(i) of this section, E's agreement to use a calendar year on Form 2553 does not mean that E has adopted a calendar year. Thus, E's desire to make a section 444 election to use a September 30 taxable year will not be considered a change in taxable year and thus paragraph (b)(2) of this section will not apply. Instead, E will be subject to paragraph (b)(1) of this section. Since a September 30 taxable year would result in only a three-month deferral period (September 30 to December 31), E may, if otherwise qualified, make a section 444 election to use a year ending September 30 for its taxable year beginning April 15, 1987.

(2) *Special rule for entities retaining their 1986 taxable year.* The following examples illustrate the provisions of paragraph (b)(3) of this section.

Example (1). F, an S corporation that elected to be an S corporation several years ago, has historically used a June 30 taxable year. F desires to retain its June 30 taxable year by making a section 444 election for its taxable year beginning July 1, 1987. Pursuant to paragraph (b)(4)(i) of this section, the deferral period of the taxable year being retained is 6 months (June 30 to December 31, F's required taxable year). Absent the special rule provided in paragraph (b)(3) of this section, F would be subject to the general rule provided in paragraph (b)(1) of this section which limits the deferral period of the taxable year elected to three months or less. However, pursuant to paragraph (b)(3) of this section, F may, if otherwise qualified, make a section 444 election to retain its year ending June 30 for its taxable year beginning July 1, 1987.

Example (2). The facts are the same as in example (1), except that F received permission from the Commissioner to change its taxable year to the calendar year, and filed a short period income tax return for the period July 1 to December 31, 1986. F desires to make a section 444 election to use a year ending June 30 for its taxable year beginning January 1, 1987. Given that F had a December 31 taxable year for its last taxable year beginning in 1986, the special rule provided in paragraph (b)(3) of this section does not allow F to use a June 30 taxable year for its taxable year beginning January 1, 1987. Furthermore, pursuant to paragraph (b)(2)(i) of this section, F is not allowed to change its taxable year from December 31 to June 30 because the deferral period of the taxable year being changed is zero months.

Example (3). G, a corporation that historically used an August 31 taxable year, elected to be an S corporation on November 15, 1986, for its taxable year beginning September 1, 1986. As a condition to obtaining S status, G agreed to use a calendar year. Thus, G filed its first S corporation return for the period September 1 to December 31, 1986. G desires to make a section 444 election to use a year ending August 31 for its taxable year beginning January 1, 1987. Since G's last taxable year beginning in 1986 was a calendar year, G cannot use paragraph (b)(3) of this section, relating to retentions of taxable years, to elect an August 31 taxable year. Thus, G is subject to paragraph (b)(2)(i) of this section, relating to changes in taxable year. Although G, if otherwise qualified, may use the special rule provided in paragraph (b)(2)(ii) of this section, G may only change from its current taxable year (*i.e.*, the calendar year) to a taxable year that has no more than a three-month deferral period (*i.e.*, September 30, October 31, or November 30).

Example (4). The facts are the same as in example (3), except that G elected to be an S corporation for its taxable year beginning September 1, 1987, rather than its taxable year beginning September 1, 1986. As a condition to making its S election, G agreed, on Form 2553, to use the calendar year. However, G has not yet filed a short period income tax return for the period September 1 to December 31, 1987. Given these facts, paragraph (b)(3) of this section would allow G, if otherwise qualified, to make a section 444 election to retain an August 31 taxable year for its taxable year beginning September 1, 1987.

Example (5). The facts are the same as in example (4), except that G has already filed a short period income tax return for the period September 1 to December 31, 1987. Pursuant to paragraph (b)(5)(ii)(A) of this section, G may supersede the return it filed for the period September 1 to December 31, 1987. Thus, pursuant to paragraph (b)(3) of this section, G may, if otherwise qualified, make a section 444 election to retain an August 31 taxable year for the taxable year beginning September 1, 1987. In addition, G should follow the special procedures set forth in paragraph (b)(5)(ii)(B) of this section.

Example (6). H, a corporation that historically used a May 31 taxable year, elects to be an S corporation on June 15, 1988 for its taxable year beginning June 1, 1988. H desires to make a section 444 election to use a taxable year other than the calendar year. Since the taxable year in issue is not H's first taxable year beginning after December 31, 1986, H may not use the special rule provided in paragraph (b)(3)(i) and thus may not retain its May 31 year. However, H may, if otherwise qualified, make a section 444 election under paragraph (b)(2)(i) of this section, to change to a taxable year that has no more than a three-month deferral period (*i.e.*, September 30, October 31, or November 30) for its taxable year beginning June 1, 1988.

Example (7). I is a partnership that has historically used a calendar year. Sixty percent of the profits and capital of I are owned by Q, a corporation (that is neither an S corporation nor a personal service corporation) that has a June 30 taxable year, and 40 percent of the profits and capital are owned by R, a calendar year individual. Since the partner that has more than a fifty percent interest in I has a June 30 taxable year, I's required taxable year is June 30. Accordingly, I filed an income tax return for the period January 1 to June 30, 1987. Based on these facts, I may, pursuant to paragraph (b)(5)(ii)(A) of this section, disregard the income tax return filed for the period January 1 to June 30, 1987. Thus, if otherwise qualified, I may make a section 444 election under paragraph (b)(2)(i) of this section to use a calendar year for its taxable year beginning January 1, 1987. If I makes such a section 444 election, I should follow the special procedures set forth in paragraph (b)(5)(ii)(B) of this section.

§1.444-2T Tiered structure (temporary).

(a) *General rule.* Except as provided in paragraph (e) of this section, no section 444 election shall be made or continued with respect to a partnership, S corporation, or personal service corporation that is a member of a tiered structure on the date specified in paragraph (d) of this section. For purposes of this section, the term "personal service corporation" means a personal service corporation as defined in §1.441-4T(d).

(b) *Definition of a member of a tiered structure*—(1) *In general.* A partnership, S corporation, or personal service corporation is considered a member of a tiered structure if—

(i) The partnership, S corporation, or personal service corporation directly owns any portion of a deferral entity, or

(ii) A deferral entity directly owns any portion of the partnership, S corporation, or personal service corporation.

However, see paragraph (c) of this section for certain de minimis rules, and see paragraph (b)(3) of this section for an anti-abuse rule. In addition, for purposes of this section, a beneficiary of a trust shall be considered to own an interest in the trust.

(2) *Deferral entity*—(i) *In general.* For purposes of this section, the term "deferral entity" means an

entity that is a partnership, S corporation, personal service corporation, or trust. In the case of an affiliated group of corporations filing a consolidated income tax return that is treated as a personal service corporation pursuant to §1.441-4T(i), such affiliated group is considered to be a single deferral entity.

(ii) *Grantor trusts.* The term "deferral entity" does not include a trust (or a portion of a trust) which is treated as owned by the grantor or beneficiary under Subpart E, part I, subchapter J, chapter 1, of the Code (relating to grantor trusts), including a trust that is treated as a grantor trust pursuant to section 1361(d)(1)(A) of the Code (relating to qualified subchapter S trusts). Thus, any taxpayer treated under subpart E as owning a portion of a trust shall be treated as owning the assets of the trust attributable to that ownership. The following examples illustrate the provisions of this paragraph (b)(2)(ii).

Example (1). A, an individual, is the sole beneficiary of T. T is a trust that owns 50 percent of the profits and capital of X, a partnership that desires to make a section 444 election. Furthermore, pursuant to Subpart E, Part I, subchapter J, chapter 1 of the Code, A is treated as an owner of X. Based upon these facts, T is not a deferral entity and 50 percent of X is considered to be directly owned by A.

Example (2). The facts are the same as in example (1), except that A is a personal service corporation rather than an individual. Given these facts, 50 percent of X is considered to be directly owned by A, a deferral entity. Thus, X is considered to be a member of a tiered structure.

(3) *Anti-abuse rule.* Notwithstanding paragraph (b)(1) of this section, a partnership, S corporation, or personal service corporation is considered a member of a tiered structure if the partnership, S corporation, personal service corporation, or related taxpayers have organized or reorganized their ownership structure or operations for the principal purpose of obtaining a significant unintended tax benefit from making or continuing a section 444 election. For purposes of the preceding sentence, a significant unintended tax benefit results when a partnership, S corporation, or personal service corporation makes a section 444 election and, as a result, a taxpayer (not limited to the entity making the election) obtains a significant deferral of income substantially all of which is not eliminated by a required payment under section 7519. See examples (15) through (19) in paragraph (f) of this section.

(c) *De minimis rules*—(1) *In general.* For rules relating to a de minimis exception to paragraph (b)(1)(i) of this section (the "downstream de minimis rule"), see paragraph (c)(2) of this section. For rules relating to a de minimis exception to paragraph (b)(1)(ii) of this section (the "upstream de minimis rule"), see paragraph (c)(3) of this section. For rules relating to the interaction of the de minimis rules provided in this paragraph (c) and the "same taxable year exception" provided in paragraph (e) of this section, see paragraph (e)(5) of this section.

(2) *Downstream de minimis rule*—(i) *General rule.* If a partnership, S corporation, or personal service corporation directly owns any portion of one or more deferral entities as of the date specified in paragraph (d) of this section, such ownership is disregarded for purposes of paragraph (b)(1)(i) of this section if, in the aggregate, all such deferral entities accounted for—

(A) Not more than 5 percent of the partnership's, S corporation's, or personal service corporation's adjusted taxable income for the testing period ("5 percent adjusted taxable income test"), or

(B) Not more than 2 percent of the partnership's, S corporation's, or personal service corporation's gross income for the testing period ("2 percent gross income test"). See section 702(c) for rules relating to the determination of gross income of a partner in a partnership. See examples (3) through (5) in paragraph (f) of this section.

(ii) *Definition of testing period.* For purposes of this paragraph (c)(2), the term "testing period" means the taxable year that ends immediately prior to the taxable year for which the partnership, S corporation, or personal service corporation desires to make or continue a section 444 election. However, see the special rules provided in paragraph (c)(2)(iv) of this section for certain special cases (*e.g.*, the partnership, S corporation, personal service corporation or deferral entity was not in existence during the entire testing period). The following example illustrates the application of this paragraph (c)(2)(ii).

Example. A partnership desires to make a section 444 election for its taxable year beginning November 1, 1987. The testing period for purposes of determining whether deferral entities owned by such partnerships are de minimis under paragraph (c)(2) of this section is the taxable year ending October 31, 1987. If either the partnership or the deferral entities were not in existence for the entire taxable year ending October 1, 1987, see the special rules provided in paragraph (c)(2)(iv) of this section.

(iii) *Definition of adjusted taxable income*—(A) *Partnership.* In the case of a partnership, adjusted taxable income for purposes of paragraph (c)(2) of this section is an amount equal to the sum of the—

(*1*) Aggregate amount of the partnership items described in section 702(a) (other than credits and tax-exempt income),

(*2*) Applicable payments defined in section 7519(d)(3) that are deducted in determining the amount described in paragraph (c)(2)(iii)(A)(*1*) of this section, and

(*3*) Guaranteed payments defined in section 707(c) that are deducted in determining the amount described in paragraph (c)(2)(iii)(A)(*1*) of this section and are not otherwise included in paragraph (c)(2)(iii)(A)(*2*) of this section. For purposes of determining the aggregate amount of partnership items under paragraph (c)(2)(iii)(A)(*1*) of this section, deductions and losses are treated as negative income. Thus, for example, if under section 702(a) a partnership has $1,000 of ordinary taxable income, $500 of specially allocated deductions, and $300 of capital loss, the partnership's aggregate amount of partnership items under paragraph (c)(2)(iii)(A)(*1*) of this section is $200 ($1,000 − $500 − $300).

(B) *S corporation.* In the case of an S corporation, adjusted taxable income for purposes of paragraph (c)(2) of this section is an amount equal to the sum of the—

(*1*) Aggregate amount of the S corporation items described in section 1366(a) (other than credits and tax-exempt income), and

(*2*) Applicable payments defined in section 7519(d)(3) that are deducted in determining the amount described in paragraph (c)(2)(iii)(B)(*1*) of this section. For purposes of determining the aggregate amount of S corporation items under paragraph (c)(2)(iii)(B)(*1*) of this section, deductions and losses are treated as negative income. Thus, for example, if under section 1366(a) an S corporation has $2,000 of ordinary taxable income, $1,000 of deductions described in section 1366(a)(1)(A) of the Code, and $500 of capital loss, the S corporation's aggregate amount of S corporation items under paragraph (c)(2)(iii)(B)(*1*) of this section is $500 ($2,000 – $1,000 – $500).

(C) *Personal service corporation.* In the case of a personal service corporation, adjusted taxable income for purposes of paragraph (c)(2) of this section is an amount equal to the sum of the—

(*1*) Taxable income of the personal service corporation, and

(*2*) Applicable amounts defined in section 280H(f)(1) that are deducted in determining the amount described in paragraph (c)(2)(iii)(C)(*1*) of this section.

(iv) *Special rules*—(A) *Pro-forma rule.* Except as provided in paragraph (c)(iv)(C)(*2*) of this section, if a partnership, S corporation, or personal service corporation directly owns any interest in a deferral entity as of the date specified in paragraph (d) of this section and such ownership interest is different in amount from the partnership's, S corporation's, or personal service corporation's interest on any day during the testing period, the 5 percent adjusted taxable income test and the 2 percent gross income test must be applied on a pro-forma basis (*i.e.*, adjusted taxable income and gross income must be calculated for the testing period assuming that the partnership, S corporation, or personal service corporation owned the same interest in the deferral entity that it owned as of the date specified in paragraph (d) of this section). The following example illustrates the application of this paragraph (c)(2)(iv)(A).

Example. A personal service corporation desiring to make a section 444 election for its taxable year beginning October 1, 1987, acquires a 25 percent ownership interest in a partnership on or after October 1, 1987. Furthermore, the partnership has been in existence for several years. The personal service corporation must modify its calculations of the 5 percent adjusted taxable income test and the 2 percent gross income test for the testing period ended September 30, 1987, by assuming that the personal service corporation owned 25 percent of the partnership during such testing period and the personal service corporation's adjusted taxable income and gross income were correspondingly adjusted.

(B) *Reasonable estimates allowed.* If the information necessary to complete the pro-forma calculation described in paragraph (c)(2)(iv)(A) of this section is not readily available, the partnership, S corporation, or personal service corporation may make a reasonable estimate of such information.

(C) *Newly formed entities*—(*1*) *Newly formed deferral entities.* If a partnership, S corporation, or personal service corporation owns any portion of a deferral entity on the date specified in paragraph (d) of this section and such deferral entity was not in existence during the entire testing period (hereinafter referred to as a "newly formed deferral entity"), both the 5 percent adjusted taxable income test and the 2 percent gross income test are modified as follows. First, the partnership, S corporation, or personal service corporation shall calculate the percentage of its adjusted taxable income or gross income that is attributable to deferral entities, excluding newly formed deferral entities. Second, the partnership, S corporation, or personal service corporation shall calculate (on the date specified in paragraph (d) of this section) the percentage of the tax basis of its assets that are attributable to its tax basis with respect to its ownership interests in all newly formed deferral entities. If the sum of the two percentages is 5 percent or less, the deferral entities are considered de minimis and are disregarded for purposes of paragraph (b)(1)(i) of this section. If the sum of the two percentages is greater than 5 percent, the deferral entities do not qualify for the de minimis rule provided in paragraph (c)(2) of this section and thus the partnership, S corporation, or personal service corporation is considered to be a member of a tiered structure for purposes of this section.

(*2*) *Newly formed partnership, S corporation, or personal service corporation desiring to make a section 444 election.* If a partnership, S corporation, or personal service corporation desires to make a section 444 election for the first taxable year of its existence, the 5 percent adjusted taxable income test and the 2 percent gross income test are replaced by a 5 percent of assets test. Thus, if on the date specified in paragraph (d) of this section, 5 percent or less of the assets (measured by reference to the tax basis of the assets) of the newly formed partnership, S corporation, or personal service corporation are attributable to the tax basis with respect to its ownership interests in the deferral entities, the deferral entities will be considered de minimis and will be disregarded for purposes of paragraph (b)(1)(i) of this section.

(3) *Upstream de minimis rule.* If a partnership, S corporation or personal service corporation is directly owned by one or more deferral entities as of the date specified in paragraph (d) of this section, such ownership is disregarded for purposes of paragraph (b)(1)(ii) of this section if on the date specified in paragraph (d) of this section the deferral entities directly own, in the aggregate, 5 percent or less of—

(i) An interest in the current profits of the partnership, or

(ii) The stock (measured by value) of the S corporation or personal service corporation.

See examples (6) and (7) in paragraph (f) of this section.

(d) *Date for determining the existence of a tiered structure*—(1) *General rule.* For purposes of paragraph (a) of this section, a partnership, S corporation, or personal service corporation will be considered a member of a tiered structure for a particular taxable year if the partnership, S corporation, or personal service corporation is a member of a tiered structure on the last day of the required taxable year (as defined in section 444(e) of the Code) ending within such year. If a particular taxable year does not include the last day of the required taxable year for such year, the partnership, S corporation, or personal service corporation will not be considered a member of a tiered structure for such year. The following examples illustrate the application of this paragraph (d)(1).

Example (1). Assume that a newly formed partnership whose first taxable year begins November 1, 1988, desires to adopt a September 30 taxable year by making a section 444 election. Furthermore, assume that for its taxable year beginning November 1, 1988, the partnership's required taxable year is December 31. If the partnership is a member of a tiered structure on December 31, 1988, it will not be eligible to make a section 444 election for a taxable year beginning November 1, 1988, and ending September 30, 1989.

Example (2). Assume an S corporation that historically used a June 30 taxable year desires to make a section 444 election to change to a year ending September 30 for its taxable year beginning July 1, 1987. If the S corporation can make the section 444 election, it will have a short taxable year beginning July 1, 1987, and ending September 30, 1987. Given these facts, the short taxable year beginning July 1, 1987, does not include the last day of the S corporation's required taxable year for such year (*i.e.*, December 31, 1987). Thus, pursuant to paragraph (d)(1) of this section, the S corporation will not be considered a member of a tiered structure for its taxable year beginning July 1, 1987, and ending September 30, 1987.

(2) *Special rule for taxable years beginning in 1987.* For purposes of paragraph (a) of this section, a partnership, S corporation, or personal service corporation will not be considered a member of a tiered structure for a taxable year beginning in 1987 if the partnership, S corporation, or personal service corporation is not a member of a tiered structure on the day the partnership, S corporation, or personal service corporation timely files its section 444 election for such year. The following examples illustrate the application of this paragraph (d)(2).

Example (1). Assume that a partnership desires to retain a June 30 taxable year by making a section 444 election for its taxable year beginning July 1, 1987. Furthermore, assume that the partnership's required taxable year for such year is December 31 and that the partnership was a member of a tiered structure on such date. Also assume that the partnership was not a member of a tiered structure as of the date it timely filed its section 444 election for its taxable year beginning July 1, 1987. Based upon the special rule provided in this paragraph (d)(2), the partnership will not be considered a member of a tiered structure for its taxable year beginning July 1, 1987.

Example (2). Assume the same facts as in example (1), except that the partnership was a member of a tiered structure on the date it filed its section 444 election for its taxable year beginning July 1, 1987, but was not a member of a tiered structure on December 31, 1987. Paragraph (d)(1) of this section would still apply and thus the partnership would not be considered part of a tiered structure for its taxable year beginning July 1, 1987. However, the partnership would be considered a member of a tiered structure for its taxable year beginning July 1, 1988, if the partnership was a member of a tiered structure on December 31, 1988.

(e) *Same taxable year exception*—(1) *In general.* Although a partnership or S corporation is a member of a tiered structure as of the date specified in paragraph (d) of this section, the partnership or S corporation may make or continue a section 444 election if the tiered structure (as defined in paragraph (e)(2) of this section) consists entirely of partnerships or S corporations (or both), all of which have the same taxable year as determined under paragraph (e)(3) of this section. However, see paragraph (e)(5) of this section for the interaction of the de minimis rules provided in paragraph (c) of this section with the same taxable year exception. For purposes of this paragraph (e), two or more entities are considered to have the same taxable year if their taxable years end on the same day, even though they begin on different days. See examples (8) through (14) in paragraph (f) of this section.

(2) *Definition of tiered structure*—(i) *General rule.* For purposes of the same taxable year exception, the members of a tiered structure are defined to include the following entities—

(A) The partnership or S corporation that desires to quality for the same taxable year exception,

(B) A deferral entity (or entities) directly owned (in whole or in part) by the partnership or S corporation that desires to qualify for the same taxable year exception,

(C) A deferral entity (or entities) directly owning any portion of the partnership or S corporation that desires to qualify for the same taxable year exception, and

(D) A deferral entity (or entities) directly owned (in whole or in part) by a "downstream controlled partnership," as defined in paragraph (e)(2)(ii) of this section.

(ii) *Special flow-through rule for downstream controlled partnerships.* If more than 50 percent of a partnership's profits and capital are owned by a partnership or S corporation that desires to qualify for the same taxable year exception, such owned partnership is considered a downstream controlled partnership for purposes of paragraph (e)(2)(i) of this section. Furthermore, if more than 50 percent of a partnership's profits and capital are owned by a downstream controlled partnership, such owned partnership is considered a downstream controlled partnership for purposes of paragraph (e)(2)(i) of this section.

(3) *Determining the taxable year of a partnership or S corporation.* The taxable year of a partnership or S corporation to be taken into account for purposes of paragraph (e)(1) of this section is the taxable year ending with or prior to the date specified in paragraph (d) of this section. Furthermore, the determination of such taxable year will take into consideration any section 444 elections made by the partnership or S corporation. See examples (10) and (11) in paragraph (f) of this section.

(4) *Special rule for 52-53-week taxable years.* For purposes of this paragraph (e), a 52-53-week taxable year with reference to the end of the particular month will be considered to be the same as a taxable year ending with reference to the last day of such month.

(5) *Interaction with de minimis rules*—(i) *Downstream de minimis rule*—(A) *In general.* If a partnership or S corporation that desires to make or continue a section 444 election is a member of a tiered structure (as defined in paragraph (e)(2) of this section) and directly owns any member (or members) of the tiered structure with a taxable year different from the taxable year of the partnership or S corporation, such ownership is disregarded for purposes of the same taxable

year exception of paragraph (e)(1) of this section provided that, in the aggregate, the de minimis rule of paragraph (c)(2) of this section is satisfied with respect to such owned member (or members). The following example illustrates the application of this paragraph (e)(5)(i)(A).

Example. P, a partnership with a June 30 taxable year, owns 60 percent of P1, another partnership with a June 30 taxable year. P also owns 1 percent of P2 and P3, calendar year partnerships. If, in the aggregate, P's ownership interests in P2 and P3 are considered de minimis under paragraph (c)(2) of this section, P meets the same taxable year exception and may make a section 444 election to retain its June 30 taxable year.

(B) *Special rule for members of a tiered structure directly owned by a downstream controlled partnership.* For purposes of paragraph (e)(5)(i)(A) of this section, a partnership or S corporation desiring to make or continue a section 444 election is considered to directly own any member of the tiered structure (as defined in paragraph (e)(2) of this section) directly owned by a downstream controlled partnership (as defined in paragraph (e)(2)(ii) of this section). The adjusted taxable income or gross income of the partnership or S corporation that is attributable to a member of a tiered structure directly owned by a downstream controlled partnership equals the adjusted taxable income or gross income of such member multiplied by the partnership's or S corporation's indirect ownership percentage of such member. The following example illustrates the application of this paragraph (e)(5)(i)(B).

Example. P, a partnership, desires to retain its June 30 taxable year by making a section 444 election. However, as of the date specified in paragraph (d) of this section, P owns 75 percent of P1, a June 30 partnership, and P1 owns 40 percent of P2, a calendar year partnership. P also owns 25 percent of P3, a calendar year partnership. Pursuant to paragraphs (e)(5)(i)(A) and (B) of this section, P may only qualify to use the same taxable year exception if, in the aggregate, P2 and P3 are de minimis with respect to P. Pursuant to paragraph (e)(5)(i)(B) of this section, P's adjusted taxable income or gross income attributable to P2 equals 30 percent (75 percent times 40 percent) of P2's adjusted taxable income or gross income.

(ii) *Upstream de minimis rule.* If a partnership or S corporation that desires to make or continue a section 444 election is a member of a tiered structure (as defined in paragraph (e)(2) of this section) and is owned directly by a member (or members) of the tiered structure with taxable years different from the taxable year of the partnership or S corporation, such ownership is disregarded for purposes of the same taxable year exception of paragraph (e)(1) of this section provided that, in the aggregate, the de minimis rule of paragraph (c)(3) of this section is satisfied with respect to such owning member (or members). See example (12) of paragraph (f) of this section.

(f) *Examples.* The provisions of this section may be illustrated by the following examples.

Example (1). A, a partnership, desires to make or continue a section 444 election. However, on the date specified in paragraph (d) of this section, A is owned by a combination of individuals and S corporations. The S corporations are deferral entities, as defined in paragraph (b)(2) of this section. Thus, pursuant to paragraph (b)(1)(ii) of this section, A will be a member of a tiered structure unless under paragraph (c)(3) of this section, the S corporations, in the aggregate, own a de minimis portion of A. If the S corporations' ownership in A is not considered de minimis under paragraph (c)(3) of this section, A is a member of a tiered structure and will be allowed to make or continue a section 444 election only if it meets the same taxable year exception provided in paragraph (e) of this section.

Example (2). B, a partnership, desires to make or continue a section 444 election. However, on the date specified in paragraph (d) of this section, B is a partner in two partnerships, B1 and B2. B1 and B2 are deferral entities, as defined in paragraph (b)(2) of this section. Thus, under paragraph (b)(1)(i) of this section, B will be a member of a tiered structure unless B's aggregate ownership interests in B1 and B2 are considered de minimis under paragraph (c)(2) of this section. If B is a member of a tiered structure on the date specified in paragraph (d) of this section, B will be allowed to make or continue a section 444 election only if it meets the same taxable year exception provided in paragraph (e) of this section.

Example (3). C, a partnership with a September 30 taxable year, is 100 percent owned by calendar year individuals. C desires to make a section 444 election for its taxable year beginning October 1, 1987. However, on the date specified in paragraph (d) of this section, C owns a 1 percent interest in C1, a partnership. C does not own any other interest in a deferral entity. For the taxable year ended September 30, 1987, 10 percent of C's adjusted taxable income (as defined in paragraph (c)(2)(iii) of this section) was attributable to C's partnership interest in C1. Furthermore, 4 percent of C's gross income for the taxable year ended September 30, 1987, was attributable to C's partnership interest in C1. Under paragraph (c)(2) of this section, C's partnership interest in C1 is not de minimis because during the testing period more than 5 percent of C's adjusted taxable income is attributable to C1 and more than 2 percent of C's gross income is attributable to C1. Thus, C is a member of a tiered structure for its taxable year beginning October 1, 1987.

Example (4). The facts are the same as example (3), except that for the taxable year ended September 30, 1987, only 2 percent of C's adjusted taxable income was attributable to C1. Under paragraph (c)(2) of this section, C's partnership interest in C1 is considered de minimis for purposes of determining whether C is a member of a tiered structure because not more than 5 percent of C's adjusted taxable income during the testing period is attributable to C1. Thus, C is not a member of a tiered structure for its taxable year beginning October 1, 1987.

Example (5). The facts are the same as example (4), except that in addition to owning C1, C also owns 15 percent of C2, another partnership. For the taxable year ended September 30, 1987, 2 percent of C's adjusted taxable income is attributable to C1 and an additional 4 percent is attributable to C2. Furthermore, for the taxable year ended September 30, 1987, 4 percent of C's gross income is attributable to C1 while 3 percent is attributable to C2. Under paragraph (c)(2) of this section, C1 and C2 must be aggregated for purposes of determining whether C meets either the 5 percent adjusted taxable income test or the 2 percent gross income test. Since C's adjusted taxable income attributable to C1 and C2 is 6 percent (2 percent + 4 percent) and C's gross income attributable to C1 and C2 is 7 percent (4 percent + 3 percent), C does not meet the downstream de minimis rule provided in paragraph (c)(2) of this section. Thus, C is a member of a tiered structure for its taxable year beginning October 1, 1987.

Example (6). The facts are the same as example (3), except that instead of determining whether C is part of a tiered structure, the issue is whether C1 is part of a tiered structure. In addition, assume that on the date specified in paragraph (d) of this section, the remaining 99 percent of C1 is owned by calendar year individuals and C1 does not own an interest in any deferral entity. Although C in Example (3) was considered to be a part of a tiered structure by virtue of its ownership interest in C1, C1 must be tested separately to determine whether it is part of a tiered structure. Since C's interest in C1 is 5 percent or less, C's interest in C1 is de minimis with respect to C1. See paragraph (c)(3) of this section. Thus, based upon these facts, C1 is not part of a tiered structure.

Example (7). The facts are the same as example (6), except that the remaining 99 percent of C1 is owned 94 percent by calendar year individuals and 5 percent by C3, another partnership. Thus, deferral entities own 6 percent of C1 (1 percent owned by C and 5 percent owned by C3). Under paragraph (c)(3) of this section, deferral entities own more than a de minimis interest (*i.e.* 5 percent) of C1, and thus C1 is part of a tiered structure.

Example (8). D, a partnership with a September 30 taxable year, desires to make a section 444 election for its taxable year beginning October 1, 1987. On December 31, 1987, and the date D plans to file its section 444 election, D is 10 percent owned by D1, a personal service corporation with a September 30 taxable year, and 90 percent owned by calendar year individuals. Furthermore, D1 will retain its September 30 taxable year because it previously established a business purpose for such year. Since D is owned in part by D1, a personal service corporation, and the ownership interest is not de minimis under paragraph (c)(3) of this section, D is considered a member of a tiered structure for its taxable year beginning October 1, 1987. Furthermore, although D and D1 have the same taxable year, D does not qualify for the same taxable year exception provided in paragraph (e) of this section because D1 is a personal service corporation rather than a partnership or S corporation. Thus, pursuant to paragraph (a) of this section, D may not make a section 444 election for its taxable year beginning October 1, 1987.

Example (9). The facts are the same as example (8), except that D1 is a partnership rather than a personal service corporation. Based upon these facts, D qualifies for the same taxable year exception provided in paragraph (e) of this section. Thus, D may make a section 444 election for its taxable year beginning October 1, 1987.

Example (10). The facts are the same as example (9), except that D1 has not established a business purpose for a September 30 taxable year. In addition, D1 does not desire to make a section 444 election and, under section 706(b), D1 will be required to change to a calendar year for its taxable year beginning October 1, 1987. Pursuant to paragraph (e)(3) of this section, D and D1 do not have the same taxable year for purposes of the same taxable year exception provided in paragraph (e) of this section. Thus, D may not make a section 444 election for its taxable year beginning October 1, 1987.

Example (11). The facts are the same as example (8), except that D1 is a partnership with a March 31 taxable year. Furthermore, for its taxable year beginning April 1, 1987, D1 will change to a September 30 taxable year by making a section 444 election. Pursuant to paragraph (e)(3) of this section, D1 is considered to have a September 30 taxable year for purposes of determining whether D qualifies for the same taxable year exception provided in paragraph (e) of this section. Since both D and D1 will have the same taxable year as of the date specified in paragraph (d) of this section, D may make a section 444 election for its taxable year beginning October 1, 1987.

Example (12). The facts are the same as example (11), except that instead of the remaining 90 percent of D being owned by calendar year individuals, it is owned 86 percent by individuals and 4 percent by D2, a calendar year partnership. Thus, D, a September 30 partnership, is 10 percent owned by D1, a September 30 partnership, 86 percent owned by calendar year individuals, and 4 percent owned by D2, a calendar year partnership. Under paragraph (e)(5)(ii) of this section, D2's ownership interest in D is considered de minimis for purposes of the same taxable year exception. Since D2's ownership interest in D is considered de minimis, it is disregarded for purposes of determining whether D qualifies for the same taxable year exception provided in paragraph (e) of this section. Thus, since both D and D1 will have the same taxable year as of the date specified in paragraph (d) of this section, D may make a section 444 election for its taxable year beginning October 1, 1987.

Example (13). E, a partnership with a June 30 taxable year, desires to make a section 444 election for its taxable year beginning July 1, 1987. On the date specified in paragraph (d) of this section, E is 100 percent owned by calendar year individuals; E owns 99 percent of the profits and capital of E1, a partnership with a June 30 taxable year; and E1 owns 30 percent of the profits and capital of E2, a partnership with a September 30 taxable year. E owns no other deferral entities. Pursuant to paragraph (b)(1)(i) of this section, E is considered to be a member of a tiered structure. Furthermore, pursuant to paragraph (e) of this section, E does not qualify for the same taxable year exception because E2 does not have the same taxable year as E and E1.

Example (14). The facts are the same as example (13), except that E owns only 49 percent (rather than 99 percent) of the profits and capital of E1. Pursuant to paragraph (e) of this section, E qualifies for the same taxable year exception because E and E1 have the same taxable year. Pursuant to paragraph (e) of this section, E1's ownership interest in E2 is disregarded since E does not own more than 50 percent of E1's profits and capital.

Example (15). Prior to consideration of the anti-abuse rule provided in paragraph (b)(3) of this section, H, a partnership that commenced operations on October 1, 1987, is eligible to make a section 444 election for its taxable year beginning October 1, 1987. Although H may obtain a significant deferral of income substantially all of which is not eliminated by a required payment under section 7519 (since there will be no required payment for H's first taxable year), the anti-abuse rule of paragraph (b)(3) will not apply unless the principal purpose of organizing H was the attainment of a significant deferral of income that would result from making a section 444 election.

Example (16). F, a partnership with a January 31 taxable year, desires to make a section 444 election to retain its January 31 taxable year for the taxable year beginning February 1, 1987. F is 100 percent owned by calendar year individuals. Prior to the date specified in paragraph (d) of this section, F contributes substantially all of its assets to F1, a partnership, in exchange for a 51 percent interest in F1. The remaining 49 percent of F1 is owned by the calendar year individuals owning 100 percent of F. If F is allowed to make a section 444 election to retain its January 31 taxable year, F1's required taxable year will be January 31 since a majority of F1's partners use a January 31 taxable year (see §1.706-3T). F's principal purpose for creating F1 and contributing its assets to F1 is to obtain an 11-month deferral on 49 percent of the income previously earned by F and now earned by F1. Pursuant to paragraph (b)(3) of this section, F is not allowed to make a section 444 election for its taxable year beginning February 1, 1987.

Example (17). The facts are the same as in example (16), except that F does not create F1 and contribute its assets to F1 until immediately after F makes its section 444 election for the taxable year beginning February 1, 1987. Thus, F is allowed to make a section 444 election for its taxable year beginning February 1, 1987. However, pursuant to paragraph (b)(3) of this section, F will have its section 444 election terminated for subsequent years unless the tax deferral inherent in the structure is eliminated (*e.g.*, F1 is liquidated or the individual owners of F contribute their interests in F1 to F) prior to the date specified in paragraph (d) of this section for subsequent taxable years beginning on or after February 1, 1988.

Example (18). The facts are the same as in example (16), except that F1 is 99 percent owned by F and none of the individual owners of F own any portion of F1. Furthermore, F obtained no tax benefit from creating and contributing assets to F1. Given these facts paragraph (b(93) of this section does not apply and thus, F may make a section 444 election for its taxable year beginning February 1, 1987.

Example (19). G, a partnership with an October 31 taxable year, desires to retain its October 31 taxable year for its taxable year beginning November 1, 1987. However, as of December 31, 1987, G owns a 30 percent interest in G1, a calendar year partnership. G owns no other deferral entity, and G is 100 percent owned by calendar year individuals. Furthermore, G's interest in G1 does not meet the de minimis rule provided in paragraph (c)(3) of this section. Thus, in order to avoid being a tiered structure, G sells its interest in G1 to an unrelated third party prior to the date G timely makes it section 444 election for its taxable year beginning November 1, 1987. Although the sale of G1 allows G to qualify to make a section 444 election, and therefore to obtain a significant tax benefit, such benefit is not unintended. Thus, paragraph (b)(3) of this section does not apply, and G may make a section 444 election for its taxable year beginning November 1, 1987.

(g) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

§1.444-3T Manner and time of making section 444 election (temporary).

(a) *In general.* A section 444 election shall be made in the manner and at the time provided in this section.

(b) *Manner and time of making election*—(1) *General rule.* A section 444 election shall be made by filing a properly prepared Form 8716, "Election to Have a Tax

Year Other Than a Required Tax Year," with the Service Center indicated by the instructions to Form 8716. Except as provided in paragraphs (b)(2) and (4) of this section, Form 8716 must be filed by the earlier of—

(i) The 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective, or

(ii) The due date (without regard to extensions) of the income tax return resulting from the section 444 election.

In addition, a copy of Form 8716 must be attached to Form 1065 or Form 1120 series form, whichever is applicable, for the first taxable year for which the section 444 election is made. Form 8716 shall be signed by any person who is authorized to sign Form 1065 or Form 1120 series form, whichever is applicable. (See sections 6062 and 6063, relating to the signing of returns). The provisions of this paragraph (b)(1) may be illustrated by the following examples.

Example (1). A, a partnership that began operations on September 10, 1988, is qualified to make a section 444 election to use a September 30 taxable year for its taxable year beginning September 10, 1988. Pursuant to paragraph (b)(1) of this section, A must file Form 8716 by the earlier of the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective (*i.e.*, February 15, 1989) or the due date (without regard to extensions) of the partnership's tax return for the period September 10, 1988 to September 30, 1988 (*i.e.*, January 15, 1989). Thus, A must file Form 8716 by January 15, 1989.

Example (2). The facts are the same as in example (1), except that A began operations on October 20, 1988. Based upon these facts, A must file Form 8716 by March 15, 1989, the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective.

Example (3). B is a corporation that first becomes a personal service corporation for its taxable year beginning September 1, 1988. B qualifies to make a section 444 election to use a September 30 taxable year for its taxable year beginning September 1, 1988. Pursuant to this paragraph (b)(1), B must file Form 8716 by December 15, 1988, the due date of the income tax return for the short period September 1 to September 30, 1988.

(2) *Special extension of time for making an election.* If, pursuant to paragraph (b)(1) of this section, the due date for filing Form 8716 is prior to July 26, 1988, such date is extended to July 26, 1988. The provisions of this paragraph (b)(2) may be illustrated by the following examples.

Example (1). B, a partnership that historically used a June 30 taxable year, is qualified to make a section 444 election to retain a June 30 taxable year for its taxable year beginning July 1, 1987. Absent paragraph (b)(2) of this section, B would be required to file Form 8716 by December 15, 1987. However, pursuant to paragraph (b)(2) of this section, B's due date for filing Form 8716 is extended to July 26, 1988.

Example (2). C, a partnership that began operations on January 20, 1988, is qualified to make a section 444 election to use a year ending September 30 for its taxable year beginning January 20, 1988. Absent paragraph (b)(2) of this section, C is required to file Form 8716 by June 15, 1988 (the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective). However, pursuant to paragraph (b)(2) of this section, the due date for filing Form 8716 is July 26, 1988.

(3) *Corporation electing to be an S corporation*—(i) *In general.* A corporation electing to be an S corporation is subject to the same time and manner rules for filing Form 8716 as any other taxpayer making a section 444 election. Thus, a corporation electing to be an S corporation that desires to make a section 444 election is not required to file Form 8716 with its Form 2553, "Election by a Small Business Corporation." However, a corporation electing to be an S corporation after September 26, 1988, is required to state on Form 2553 its intention to—

(A) Make a section 444 election, if qualified, or

(B) Make a "back-up section 444 election" as described in paragraph (b)(4) of this section.

If a corporation electing to be an S corporation fails to state either of the above intentions, the District Director may, at his discretion, disregard any section 444 election for such taxpayer.

(ii) *Examples.* The provisions of this paragraph (b)(3) may be illustrated by the following examples.

Example (1). D is a corporation that commences operations on October 1, 1988, and elects to be an S corporation for its taxable year beginning October 1, 1988. All of D's shareholders use the calendar year as their taxable year. D desires to adopt a September 30 taxable year. D does not believe it has a business purpose for a September 30 taxable year and thus it must make a section 444 election to use such year. Based on these facts, D must, pursuant to the instructions to Form 2553, state on Form 2553 that, if qualified, it will make a section 444 election to adopt a year ending September 30 for its taxable year beginning October 1, 1988. If D is qualified (*i.e.*, D is not a member of a tiered structure on December 31, 1988) to make a section 444 election for its taxable year beginning October 1, 1988, D must file Form 8716 by March 15, 1989. If D ultimately is not qualified to make a section 444 election for its taxable year beginning October 1, 1988, D's election to be an S corporation will not be effective unless, pursuant to the instructions to Form 2553, D made a back-up calendar year election (*i.e.*, an election to adopt the calendar year in the event D ultimately is not qualified to make a section 444 election for such year).

Example (2). The facts are the same as in example (1), except that D believes it can establish, to the satisfaction of the Commissioner, a business purpose for adopting a September 30 taxable year. However, D desires to make a "back-up section 444 election" (see paragraph (b)(4) of this section) in the event that the Commissioner does not grant permission to adopt a September 30 taxable year based upon business purpose. Based on these facts, D must, pursuant to the instructions to Form 2553, state on Form 2553 its intention, if qualified, to make a back-up section 444 election to adopt a September 30 taxable year. If, by March 15, 1989, D has not received permission to adopt a September 30 taxable year and D is qualified to make a section 444 election, D must make a back-up election in accordance with paragraph (b)(4) of this section.

(4) *Back-up section 444 election*—(i) *General rule.* A taxpayer that has requested (or is planning to request) permission to use a particular taxable year based upon business purpose, may, if otherwise qualified, file a section 444 election (referred to as a "back-up section 444 election"). If the Commissioner subsequently denies the business purpose request, the taxpayer will, if otherwise qualified, be required to activate the back-up section 444 election. See examples (1) and (2) in paragraph (b)(4)(iv) of this section.

(ii) *Procedures for making a back-up section 444 election.* In addition to following the general rules provided in this section, a taxpayer making a back-up section 444 election should, in order to allow the Service to process the affected returns in an efficient manner, type or legibly print the words "BACK-UP ELECTION" at the top of Form 8716, "Election to Have a Tax Year Other Than a

Required Tax Year." However, if such Form 8716 is filed on or after the date a Form 1128, Application for Change in Accounting Period, is filed with respect to a period that begins on the same date, the words "FORM 1128 BACK-UP ELECTION" should be typed or legibly printed at the top of Form 8716.

(iii) *Procedures for activating a back-up section 444 election*—(A) *Partnerships and S corporations*—(*1*) *In general.* A back-up section 444 election made by a partnership or S corporation is activated by filing the return required in §1.7519-2T(a)(2)(i) and making the payment required in §1.7519-1T. The due date for filing such return and payment will be the later of—

(*i*) The due dates provided in §1.7519-2T, or

(*ii*) 60 days from the date the Commissioner denies the business purpose request.

However, interest will be assessed (at the rate provided in section 6621(a)(2)) on any required payment made after the due date (without regard to any extension for a back-up election) provided in §1.7519-2T(a)(4)(i) or (a)(4)(ii), whichever is applicable, for such payment. Interest will be calculated from such due date to the date such amount is actually paid. Interest assessed under this paragraph will be separate from any required payments. Thus, interest will not be subject to refund under §1.7519-2T.

(*2*) *Special rule if Form 720 used to satisfy return requirement.* If, pursuant to §1.7519-2T(a)(3), a partnership or S corporation must use Form 720, "Quarterly Federal Excise Tax Return," to satisfy the return requirement of §1.7519-2T (a)(2), then in addition to following the general rules provided in §1.7519-2T, the partnership or S corporation must type or legibly print the words "ACTIVATING BACK-UP ELECTION" on the top of Form 720. A partnership or S corporation that would otherwise file a Form 720 on or before the date specified in paragraph (b)(4)(iii)(A)(*1*) of this section may satisfy the return requirement by including the necessary information on such Form 720. Alternatively, such partnership or S corporation may file an additional Form 720 (*i.e.*, a Form 720 separate from the Form 720 it would otherwise file). Thus, for example, if the due date for activating an S corporation's back-up election is November 15, 1988, and the S corporation must file a Form 720 by October 31, 1988, to report manufacturers excise tax for the third quarter of 1988, the S corporation may use that Form 720 to activate its back-up election. Alternatively, the S corporation may file its regular Form 720 that is due October 31, 1988, and file an additional Form 720 by November 15, 1988, activating its back-up election.

(B) *Personal service corporations.* A back-up section 444 election made by a personal service corporation is activated by filing Form 8716 with the personal service corporation's original or amended income tax return for the taxable year in which the election is first effective, and typing or legibly printing the words—"ACTIVATING BACK-UP ELECTION" on the top of such income tax return.

(iv) *Examples.* The provisions of this paragraph (b)(4) may be illustrated by the following examples. Also see example (2) in paragraph (b)(3) of this section.

Example (1). E, a partnership that historically used a June 30 taxable year, requested (pursuant to section 6 of Rev. Proc. 87-32, 1987-28 I.R.B. 14) permission from the Commissioner to retain a June 30 taxable year for its taxable year beginning July 1, 1987. Furthermore, E is qualified to make a section 444 election to retain a June 30 taxable year for its taxable year beginning July 1, 1987. However, as of the date specified in paragraph (b)(2) of this section, the Commissioner has not determined whether E has a valid business purpose for retaining its June 30 taxable year. Based on these facts, E may, by the date specified in paragraph (b)(2) of this section, make a back-up section 444 election to retain its June 30 taxable year.

Example (2). The facts are the same as in example (1). In addition, on August 12, 1988, the Internal Revenue Service notifies E that its business purpose request is denied. E asks for reconsideration of the Service's decision, and the Service sustains the original denial on September 30, 1988. Based on these facts, E must activate its back-up section 444 election within 60 days after September 30, 1988.

Example (3). The facts are the same as in example (1), except that E desires to make a section 444 election to use a year ending September 30 for its taxable year beginning July 1, 1987. Although E qualifies to make a section 444 election to retain its June 30 taxable year, E may make a back-up section 444 election for a September 30 taxable year.

(c) *Administrative relief*—(1) *Extension of time to file income tax returns*—(i) *Automatic extension.* If a partnership, S corporation, or personal service corporation makes a section 444 election (or does not make a section 444 election, either because it is ineligible or because it decides not to make the election, and therefore changes to its required taxable year) for its first taxable year beginning after December 31, 1986, the due date for filing its income tax return for such year shall be the later of—

(A) The due date established under—

(*1*) Section 6072, in the case of Form 1065,

(*2*) §1.6037-1(b), in the case of Form 1120S,

(*3*) Section 6072(b), in the case of other Form 1120 series form; or

(B) August 15, 1988.

The words "SECTION 444 RETURN" should, in order to allow the Service to process the affected returns in an efficient manner, be typed or legibly printed at the top of the Form 1065 or Form 1120 series form, whichever is applicable, filed under this paragraph (c)(1)(i).

(ii) *Additional extensions.* If the due date of the income tax return for the first taxable year beginning after December 31, 1986, extended as provided in paragraph (c)(1)(i)(B) of this section, occurs before the date that is 6 months after the date specified in paragraph (c)(1)(i)(A) of this section, the partnership, S corporation, or personal service corporation may request an additional extension or extensions of time (up to 6 months after the date specified in paragraph (c)(1)(i)(A) of this section) to file its income tax return for such first taxable year. The request must be made by the later of the date specified in paragraph (c)(1)(i)(A) or (c)(1)(i)(B) of this section and must be made on Form 7004, "Application for Automatic Extension of Time To File Corporation Income Tax Return", or Form 2758, "Application for Extension of

Time to File U.S. Partnership, Fiduciary, and Certain Other Returns," whichever is applicable, in accordance with the form and its instructions. In addition, the following words should be typed or legibly printed at the top of the form—"SECTION 44 REQUEST FOR ADDITIONAL EXTENSION."

(iii) *Examples.* The provisions of paragraph (c)(1) of this section may be illustrated by the following examples.

Example (1). G, a partnership that historically used a January 31 taxable year, makes a section 444 election to retain such year for its taxable year beginning February 1, 1987. Absent paragraph (c)(1)(i) of this section, G's Form 1065 for the taxable year ending January 31, 1988, is due on or before May 15, 1988. However, if G types or legibly prints "SECTION 444 RETURN" at the top of Form 1065 for such year, paragraph (c)(1)(i) of this section automatically extends the due date of such return to August 15, 1988.

Example (2). The facts are the same as in example (1), except that G desires to extend the due date of its income tax return for the year ending January 31, 1988, to a date beyond August 15, 1988. Pursuant to paragraph (c)(1)(ii) of this section, G may extend such return to November 15, 1988 (*i.e.*, the date that is up to 6 months after May 15, 1988, the normal due date of the return). However, in order to obtain this additional extension, G must file Form 2758 pursuant to paragraph (c)(1)(i) of this section on or before August 15, 1988.

Example (3). H, a partnership that historically used a May 31 taxable year, makes a section 444 election to use a year ending September 30 for its taxable year beginning on June 1, 1987. Absent paragraph (c)(1)(i) of this section, H's Form 1065 for the taxable year beginning June 1, 1987, and ending September 30, 1987, is due on or before January 15, 1988. However, if H types or legibly prints "SECTION 444 RETURN" at the top of Form 1065 for such year, paragraph (c)(1)(i) of this section automatically extends the due date of such return to August 15, 1988.

Example (4). The facts are the same as in example (3), except H desires to further extend (*i.e.*, extend beyond August 15, 1988) the due date of its income tax return for its taxable year beginning June 1, 1987, and ending September 30, 1987. Since August 15, 1988, is 6 months or more after the due date (without extensions) of such return, paragraph (c)(1)(ii) of this section prevents H from further extending the time for filing such return.

Example (5). I, a partnership that historically used a June 30 taxable year, considered making a section 444 election to retain such taxable year, but eventually decided to change to a December 31 taxable year (I's required taxable year). Absent paragraph (c)(1)(i) of this section, I's Form 1065 for the taxable year beginning July 1, 1987, and ending December 31, 1987, is due on or before April 15, 1988. Pursuant to paragraph (c)(1)(i) of this section, if I types or legibly prints "SECTION 444 RETURN" at the top of Form 1065 for such year, paragraph (c)(1)(i) of this section automatically extends the due date of such return to August 15, 1988. In addition, I may further extend such return pursuant to paragraph (c)(1)(ii) of this section.

(2) *No penalty for certain late payments*—(i) *In general.* In the case of a personal service corporation or S corporation described in paragraph (c)(1)(i) of this section, no penalty under section 6651(a)(2) will be imposed for failure to pay income tax (if any) for the first taxable year beginning after December 31, 1986, but only for the period beginning with the last date for payment and ending with the later of the date specified in paragraph (c)(1)(i) or paragraph (c)(1)(ii) of this section.

(ii) *Example.* The provisions of paragraph (c)(2)(i) of this section may be illustrated by the following example.

Example. J, a personal service corporation that historically used a January 31 taxable year, makes a section 444 election to retain such year for its taxable year beginning February 1, 1987. The last date (without extension) for payment of J's income tax (if any) for its taxable year beginning February 1, 1987, is April 15, 1988. However, under paragraph (c)(2)(i) of this section, no penalty under section 6651(a)(2) will be imposed on any underpayment of income tax for the period beginning April 15, 1988 and ending August 15, 1988.

(d) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

Par. 3. Sections 1.7519-0T through 1.7519-3T are added in the appropriate place.

§1.7519-0T Table of contents (temporary).

This section lists the captions that appear in the temporary regulations under section 7519.

§1.7519-1T Required payments for entities electing not to have required year (temporary).

(a) In general.
(1) Applicability.
(2) Returns and required payments.
(3) Required payment.
(4) Examples.
(b) Definitions and special rules.
(1) Applicable percentage.
(i) In general.
(ii) Exception for certain applicable election years beginning after 1987.
(iii) Example.
(2) Adjusted highest section 1 rate.
(i) General rule.
(ii) Period for determining highest section 1 rate.
(3) Base year.
(4) Special rules for certain applicable election years.
(i) First applicable election year of new entities.
(ii) Applicable election years ending prior to the required taxable year.
(5) Net base year income.
(i) In general.
(ii) Partnership net income.
(A) In general.
(B) Treatment of deductions and losses.
(C) Partner limitations disregarded.
(iii) S corporation net income.
(A) In general.
(B) Treatment of deductions and losses.
(C) Shareholder limitations disregarded.
(iv) Applicable payments.
(A) In general.
(B) Exceptions.
(C) Special rule for corporation electing S status.
(D) Special rules for certain payments.
(*1*) Certain indirect payments.
(*2*) Payments by a downstream controlled partnership.
(*i*) In general.
(*ii*) Definition of a downstream controlled partnership.
(*3*) Examples.
(v) Special rule for base year of less than twelve months.
(A) In general.
(B) Annualized short base year income.
(vi) Examples.
(c) Refunds of required payments.
(d) Examples.

§1.7519-2T Required payments—procedures and administration (temporary).

- (a) Payment and return required.
  - (1) In general.
  - (2) Return required.
    - (i) In general.
    - (ii) Procedure if amount for applicable election year (and all preceding years) is not greater than $500.
  - (3) Time and place for filing return.
    - (i) Applicable election years beginning in 1987.
      - (A) Taxpayers that would otherwise file Form 720 for the second quarter of 1988.
      - (B) Other taxpayers.
    - (ii) Applicable election years beginning after 1987.
      - (A) Return made on Form 720.
      - (B) Return made on form other than Form 720.
    - (iii) Special rule for back-up section 444 election.
  - (4) Time and place for making required payment.
    - (i) Applicable election years beginning in 1987.
    - (ii) Applicable election years beginning after 1987.
    - (iii) Special rule for back-up section 444 election.
  - (5) Penalties for failure to pay.
  - (6) Refund of required payment.
    - (i) In general.
    - (ii) Procedures for claiming refund.
    - (iii) Interest on refund
- (b) Assessment and collection of payment.
- (c) Termination due to willful failure.
- (d) Negligence and fraud penalties made applicable.

§1.7519-3T Effective date (temporary).

§1.7519-1T Required payments for entities electing not to have required year (temporary).

(a) *In general*—(1) *Applicability.* This section applies to any taxable year that a partnership or S corporation has an election under section 444 in effect (an "applicable election year").

(2) *Returns and required payments.* For each applicable election year, a partnership or S corporation must—

(i) File a return as provided in §1.7519-2T(a)(2), and

(ii) Make a required payment (as defined in paragraph (a)(3) of this section) as provided in §1.7519-2T.

However, if the required payment for an applicable election year is not more than $500 and the partnership or S corporation has not been required to make a required payment for a prior year, the partnership or S corporation should not make a required payment for such applicable election year.

(3) *Required payment.* The term "required payment" means, with respect to any applicable election year, an amount equal to the excess of—

(i) The product of the applicable percentage of the adjusted highest section 1 rate, multiplied by the net base year income (as defined in paragraph (b)(5) of this section) of the entity, over

(ii) The cumulative amount of required payments actually made for all preceding applicable election years (reduced by the cumulative amount of such payments refundable under section 7519(c) for all such preceding years). Furthermore, the amount of the required payment is determined without regard to the required payment of any other partnership or S corporation. See example (3) in paragraph (d) of this section.

(4) *Examples.* The provisions of paragraph (a) of this section may be illustrated by the following examples.

Example (1). A, a partnership, makes a section 444 election to retain its taxable year ending September 30. For A's first applicable election year, A's required payment, as defined in paragraph (a)(3) of this section, is $400. Thus, A does not have to make a required payment for that year. However, A is required to file the return prescribed by §1.7519-2T(a)(2).

Example (2). The facts are the same as in example (1), and, in addition to those facts, for A's second applicable election year, the amount determined under paragraph (a)(3)(i) of this section is $800. Because A did not actually make a required payment for A's first applicable election year, A's required payment is $800 for its second applicable election year. Since the required payment is greater than $500, A must make a required payment for its second applicable election year. Furthermore, A must file the return prescribed by §1.7519-2T(a)(2).

Example (3). The facts are the same as in example (2), and, in addition to those facts, for A's third applicable election year, the amount determined under paragraph (a)(3)(i) is $1,200. Thus, A's required payment is $400 ($1,200 determined under paragraph (a)(3)(i) of this section less $800 determined under paragraph (a)(3)(ii) of this section). Although A's required payment for its third applicable election year is not more than $500, A must make its required payment for such year because the required payment for a preceding applicable election year exceeded $500. A must also file the return prescribed by §1.7519-2T(a)(2) for its third applicable election year.

(b) *Definitions and special rules*—(1) *Applicable percentage*—(i) *In general.* Except as provided in paragraph (b)(1)(ii) of this section, the term "applicable percentage" means the percentage determined in accordance with the following table:

If the applicable election year of the partnership or S corporation begins during:	The applicable percentage is:
1987	25
1988	50
1989	75
1990 or thereafter	100

(ii) *Exception for certain applicable election years beginning after 1987.* [Reserved.]

(iii) *Example.* The provisions of paragraph (b)(1) of this section may be illustrated by the following example.

Example. B is a corporation that has historically used a June 30 taxable year. For its taxable year beginning July 1, 1987, B elects to be an S corporation and elects under section §1.444-1T(b)(3) to retain its June 30 taxable year. Had B changed to a calendar year, its required year under section 1378, B's shareholders would not have been entitled to the 4-year spread under section 806(e)(2)(C) of the Tax Reform Act of 1986 because B was not an S corporation for its taxable year beginning in 1986. Nevertheless, for purposes of determining the required payment for B's applicable election year beginning July 1, 1987, the applicable percentage is 25 percent.

(2) *Adjusted highest section 1 rate*—(i) *General rule.* For any applicable election year, the term "adjusted highest section 1 rate" means the highest rate of tax under section 1 applicable to the period defined in paragraph (b)(2)(ii) of this section, plus 1 percentage point. Notwithstanding the preceding sentence, the adjusted highest section 1 rate is 36 percent for

applicable election years beginning in 1987. For purposes of this section, the highest rate of tax is determined without regard to the effect of section 1(g), relating to the phaseout of the 15-percent rate and personal exemptions.

(ii) *Period for determining highest section 1 rate.* For purposes of paragraph (b)(2)(i) of this section, the period for determining the highest rate of tax under section 1 is the 12 month period that—

(A) Ends with the required taxable year for the applicable election year, and

(B) Includes the end of the base year.

For example, assume that a partnership's applicable election year begins on October 1, 1988 and that the required taxable year for such applicable election year is December 31. Based upon these facts, the period for determining the highest section 1 rate is the 12-month period ending December 31, 1988.

(3) *Base year.* The term "base year" means, with respect to any applicable election year, the taxable year of the partnership or S corporation preceding such applicable election year.

(4) *Special rules for certain applicable election years*—(i) *First applicable election year of new entities.* If an applicable election year is a partnership's or S corporation's first year in existence (*i.e.*, the partnership or S corporation is newly formed and therefore does not have a base year), the required payment for such applicable election year is zero.

(ii) *Applicable election years ending prior to the required taxable year.* If a partnership or S corporation makes a section 444 election and the resulting applicable election year (the "first applicable election year") of the partnership or S corporation ends prior to the last day of the required year, the required payment for the first applicable election year is zero. See example (5) in paragraph (b)(5)(vi) of this section.

(5) *Net base year income*—(i) *In general.* Except as provided in paragraph (b)(5)(v) of this section (relating to short base years), the net base year income of a partnership or S corporation is the sum of—

(A) The deferral ratio multiplied by the partnership's or S corporation's net income for the base year, plus

(B) The excess (if any) of—

(*1*) The deferral ratio multiplied by the aggregate amount of applicable payments made by the partnership or S corporation during the base year, over

(*2*) The aggregate amount of such applicable payments made during the deferral period of the base year. The term "deferral ratio" means the ratio which the number of months in the deferral period (as defined in §1.444-1T(b)(4)) of the applicable election year bears to 12 months.

(ii) *Partnership net income.* For purposes of paragraph (b)(5)(i) of this section—

(A) *In general.* The net income of the partnership is the amount (not below zero) determined by taking into account the aggregate amount of the partnership's items described in section 702(a), except for—

(*1*) Credits,

(*2*) Tax-exempt income, and

(*3*) Guaranteed payments under section 707(c).

(B) *Treatment of deductions and losses.* For purposes of determining the aggregate amount of partnership items, deductions and losses are treated as negative income. Thus, for example, if under section 702(a) a partnership has $1,000 of ordinary taxable income, $500 of specially allocated deductions, and $300 of capital loss, the net income of the partnership is $200 ($1,000 – $500 – $300).

(C) *Partner limitations disregarded.* Any limitation on the amount of a partnership item described in section 702(a) which may be taken into account for purposes of computing the taxable income of a partner shall be disregarded in computing the net income of the partnership.

(iii) *S corporation net income.* For purposes of paragraph (b)(5)(i) of this section—

(A) *In general.* The net income of an S corporation is the amount (not below zero) determined by taking into account the aggregate amount of the S corporation's items described in section 1366(a) (other than credits and tax-exempt income). If the S corporation was a C corporation for the base year, the taxable income of the C corporation shall be treated as the net income of the S corporation for such year.

(B) *Treatment of deductions and losses.* For purposes of determining the aggregate amount of S corporation items, deductions and losses are treated as negative income. Thus, for example, if under section 1366(a) an S corporation has $2,000 of ordinary taxable income, $1,000 of deductions described in section 1366(a)(1)(A) of the Code, and $500 of capital loss, the net income of the S corporation is $500 ($2,000 – $1,000 – $500).

(C) *Shareholder limitations disregarded.* Any limitation on any amount described in section 1366(a) which may be taken into account for purposes of computing the taxable income of a shareholder shall be disregarded in computing the net income of the S corporation.

(iv) *Applicable payments*—(A) *In general.* The term "applicable payment" means any amount deductible in the base year that is includible at any time, directly or indirectly, in the gross income of a taxpayer that during the base year is a partner or shareholder.

(B) *Exceptions.* The term "applicable payment" does not include any guaranteed payments under section 707(c).

(C) *Special rule for corporation electing S status.* If an S corporation was a C corporation for the base year, the corporation shall be treated as if it were an S corporation for the base year for purposes of determining the amount of applicable payments under this section. Thus, amounts deductible by the C corporation in the base year that are includible at any time in the gross income of a taxpayer that is a shareholder during the base year are treated as if from an S corporation, and therefore within the meaning of the term "applicable payments."

(D) *Special rules for certain payments*—(*1*) *Certain indirect pay-*

ments. For purposes of paragraph (b)(5)(iv)(A) of this section, an amount is indirectly includible in the gross income of a partner or shareholder of a partnership or S corporation that has a section 444 election in effect (an electing partnership or S corporation) if the amount is includible in the gross income of—

(*i*) The spouse (other than a spouse who is legally separated from the partner or shareholder under a decree of divorce or separate maintenance) or child (under age 14) of such partner or shareholder, or

(*ii*) A corporation more than 50 percent (measured by fair market value) of which is owned in the aggregate by partners or shareholders (and individuals related under paragraph (b)(5)(iv)(D)(*1*)(*i*) of this section to any such partners or shareholders), of the electing partnership or S corporation, or

(*iii*) A partnership more than 50 percent of the profits and capital of which is owned in the aggregate by partners or shareholders (and individuals related under paragraph (b)(5)(iv)(D)(*1*)(*i*) of this section to any such partners or shareholders) of the electing partnership or S corporation, or

(*iv*) A trust more than 50 percent of the beneficial ownership of which is owned in the aggregate by partners or shareholders (and individuals related under paragraph (b)(5)(iv)(D)(*1*)(*i*) of this section to any such partners or shareholders), of the electing partnership or S corporation. For purposes of this paragraph (b)(5)(iv)(D)(*1*), ownership by any person described in this paragraph (b)(5)(iv)(D)(*1*) shall be treated as ownership by the partners or shareholders of the electing partnership or S corporation. This paragraph (b)(5)(iv)(D)(*1*) does not apply to amounts deductible by a partnership or S corporation that has made a section 444 election (the "deducting partnership") and included in the gross income of a partnership or S corporation defined in paragraphs (b)(5)(iv)(D)(*1*)(*ii*) or (*iii*) of this section (the "including partnership"), if the including partnership has the same taxable year as the deducting partnership and the including partnership has a section 444 election in effect. Furthermore, notwithstanding the general effective date provided in §1.7519-3T, this paragraph (b)(5)(iv)(D)(*1*) is effective for amounts deductible on or after June 1, 1988.

(*2*) *Payments by a downstream controlled partnership*—(*i*) *In general.* If a partnership or S corporation has made a section 444 election, any amounts deducted by a downstream controlled partnership will be considered deducted by the partnership or S corporation that has made the section 444 election for purposes of determining the applicable payments of the partnership or S corporation that has made the section 444 election.

(*ii*) *Definition of a downstream controlled partnership.* If a partnership or S corporation that has made a section 444 election owns more than 50 percent of a partnership's profits and capital, such owned partnership is considered a downstream controlled partnership for purposes of paragraph (b)(5)(iv)(D)(*2*)(*i*) of this section. Furthermore, if more than 50 percent of a partnership's profits and capital are owned by a downstream controlled partnership, such owned partnership is considered a downstream controlled partnership for purposes of paragraph (b)(5)(iv)(D)(*2*)(*i*) of this section.

(*3*) *Examples.* The provisions of this paragraph (b)(5)(iv)(D) may be illustrated by the following examples.

Example (1). I1 and I2, calendar year individuals, own 100 percent of the profits and capital of C1, a partnership. In addition to owning C1, I1 and I2 also own 100 percent of the profits and capital of C2, a calendar year partnership. For its taxable years beginning February 1, 1987, 1988, and 1989, C1 has a section 444 election in effect to use a January 31 taxable year. During its base years beginning February 1, 1986, 1987, and 1988, C1 deducted $10,000, $11,000, and $12,000, respectively that was included in C2's gross income. Furthermore, of the $12,000 deducted by C1 for its taxable year beginning February 1, 1988, $7,000 was deducted during the period June 1, 1988 to January 31, 1989. Pursuant to paragraph (b)(5)(iv)(D)(*1*) of this section, the $7,000 deducted by C1 on or after June 1, 1988, and included in C2's gross income is considered an applicable payment for C1's base year beginning February 1, 1988. Amounts deducted by C1 prior to June 1, 1988, are not subject to paragraph (b)(5)(iv)(D)(*1*) of this section.

Example (2). The facts are the same as in example (1), except that I1 and I2 own only 51 percent of C2's profits and capital. Since the two partners in C1 (*i.e.*, I1 and I2) own more than 50 percent of C2's profits and capital, C2 is considered controlled by the partners of C1 pursuant to paragraph (b)(5)(iv)(D)(*1*)(*iii*) of this section. Thus, the conclusions in example (1) are unchanged. Furthermore, if the $7,000 deducted by C1 was included in the income of a partnership more than 50 percent of the profits and capital of which is owned by C2, such $7,000 would be considered an applicable payment for its base year beginning February 1, 1988.

Example (3). The facts are the same as in example (1), except that for its taxable years beginning February 1, 1987, 1988, and 1989, C2 has a section 444 election in effect to use a January 31 taxable year. Since both C1 and C2 have the same taxable year and both have section 444 elections in effect, paragraph (b)(5)(iv)(D)(*1*) of this section does not apply to the $7,000 deducted by C1 for its base year beginning February 1, 1988.

Example (4). I3 and I4, calendar year individuals, own 100 percent of the profits and capital of C3, a partnership. C3 has made a section 444 election to retain a year ending June 30 for its taxable year beginning July 1, 1987. Furthermore, C3 owns more than 50 percent of the profits and capital of C4, a partnership that historically used a June 30 taxable year. Pursuant to §1.706-3T(b), C4 retains its year ending June 30 for its taxable year beginning July 1, 1987. For its taxable year beginning July 1, 1986, C4 deducted $20,000 that was included in I3's gross income. Pursuant to paragraph (b)(5)(iv)(D)(*2*) of this section, the $20,000 deducted by C4 is considered an applicable payment by C3 for its base year beginning July 1, 1986.

Example (5). The facts are the same as in example (4), except that the $20,000 deducted by C4 is included in the gross income of a calendar year partnership 100 percent owned by I3 and I4. Pursuant to paragraphs (b)(5)(iv)(D)(*1*) and (*2*) of this section, the $20,000 deducted by C4 is considered an applicable payment by C3 for its base year beginning July 1, 1986.

Example (6). The facts are the same as in example (4), except that instead of directly owning a portion of C4, C3 owns more than 50 percent of the profits and capital of C5. Furthermore, C5 owns more than 50 percent of the profits and capital of C4. Pursuant to paragraph (b)(5)(iv)(D)(*2*)(*ii*) of this section, both C5 and C4 are considered downstream controlled partnerships of C3. Thus, pursuant to paragraph (b)(5)(iv)(D)(*2*)(*i*) of this section, the $20,000 deducted by C4 is considered an applicable payment by C3 for its base year beginning July 1, 1986.

(v) *Special rule for base year of less than twelve months*—(A) *In general.* If a base year is a taxable year of less than twelve months (a "short base year"), net base year income for such year is an amount equal to the excess, if any, of—

(*1*) The deferral ratio multiplied by the annualized short base year income, over

(*2*) Applicable payments made during the deferral period of the applicable election year following the base year.

(B) *Annualized short base year income.* The annualized short base year income is determined by—

(*1*) Increasing the net income for the short base year by applicable payments deductible in the short base year, and

(*2*) Multiplying the short base year income as increased in paragraph (b)(5)(v)(B)(*1*) of this section by twelve, and dividing the result by the number of months in the short base year.

(vi) *Examples.* The provisions of paragraph (b)(5) of this section may be illustrated by the following examples.

Example (1). D, a partnership, is owned 10 percent by a C corporation with a September 30 taxable year and 90 percent by calendar year individuals. D has historically used a September 30 taxable year. For its taxable year beginning October 1, 1987, D makes a section 444 election to retain its September 30 taxable year. For the base year from October 1, 1986 to September 30, 1987, D has net income of $200,000 and no applicable payments. D's deferral ratio is 3/12 (the ratio of the number of months in the deferral period to 12 months). Based upon these facts, D has net base year income of $50,000 ($200,000 × 3/12).

Example (2). The facts are the same as in example (1) except that D's net income for the base year is $140,000, after applicable payments of $60,000. Of the applicable payments $15,000 were deductible during the deferral period of the base year. Based upon these facts, D has net base year income of $35,000, determined as follows:

Net income multiplied by deferral ratio	$140,000 × 3/12		
		$35,000	
Plus the excess, if any, of applicable payments multiplied by deferral ratio	$60,000 × 3/12		
		$15,000	
over aggregate amount of applicable payments deductible during deferral period of base year		$15,000	-0-
Net base year income		$35,000	

Example (3). The facts are the same as in example (2) except that of the $60,000 applicable payments only $10,000 are deductible during the deferral period of the base year. Based on these facts, D has net base year income of $40,000, determined as follows:

Net income multiplied by deferral ratio	$140,000 × 3/12		
			$35,000
plus the excess, if any, of applicable payments multiplied by deferral ratio	$60,000 × 3/12		
		$15,000	
over aggregate amount of applicable payments deductible during deferral period of base year	$10,000		
			$5,000
Net base year income			$40,000

Example (4). E is a C corporation that has historically used a January 31 taxable year. For its taxable year beginning February 1, 1987, E makes an election to be an S corporation and also makes a section 444 election to retain its January 31 taxable year. E's taxable income for the taxable year beginning February 1, 1986 to January 31, 1987 is $120,000. Pursuant to paragraph (b)(5)(iii)(A) of this section, the base year for X's first applicable election year is the taxable year beginning February 1, 1986 and ending January 31, 1987. Thus, E's net income for the base year is $120,000. During the base year, E pays its sole shareholder, A, a salary of $5,000 a month plus a $30,000 bonus on January 15, 1987. Thus, under paragraph (b)(5)(iv)(C) of this section, E's applicable payments for the base year are $90,000, of which $55,000 are applicable payments deductible during the deferral period of the base year (February 1 to December 31, 1986). Based upon these facts, E's net base year income is $137,500, determined as follows:

Net income multiplied by deferral ratio	$120,000 × 11/12		
			$110,000
plus the excess, if any, of applicable payments multiplied by the deferral ratio	$90,000 × 11/12		
		$82,500	
over aggregate amount of applicable payments deductible during deferral period of base year		$55,000	$27,500
Net base year income			$137,500

Example (5). E, a corporation that has historically used a taxable year ending July 31, makes an election to be an S corporation for its taxable year beginning August 1, 1987. For that year, E also makes a section 444 election to use a taxable year ending September 30. Thus, E has two applicable election years beginning in 1987, the first beginning August 1, 1987 and ending September 30, 1987, and the second beginning October 1, 1987 and ending September 30, 1988. E's required year under section 1378 is the calendar year. Because E's first applicable election year ends prior to the last day of E's required year (*i.e.*, December 31, 1987), the required payment for E's first applicable election year is zero. However, E is required to file a return for such year as provided in § 1.7519-2T.

Example (6). The facts are the same as in example (5). E's second applicable election year is the year from October 1, 1987 to September 30, 1988, and the base year for the second applicable election year is a period of less than 12 months (i.e., August 1, 1987 to September 30, 1987). Thus, E must compute its net base year income using the special rule for short base years provided in paragraph (b)(5)(v) of this section. Assume E's net income for the short base year is $50,000, and E's applicable payments for the short base year are $15,000. Pursuant to paragraph (b)(5)(v)(B) of this section, E's annualized short base year net income is $390,000 ($65,000 × 12/2). Furthermore, assume E's applicable payments for the deferral period of its second applicable election year are $20,000. Based on these facts, the net base year income for the applicable election year beginning October 1, 1987 is $77,500, computed as follows:

Annualized short base year income multiplied by deferral ratio	$390,000 × 3/12	
		$97,500
less: applicable payments for deferral period		$20,000
Net base year income		$77,500

(c) *Refunds of required payments.* A partnership or S corporation is entitled to make a claim for refund, in accordance with the procedures provided in §1.7519-2T (a)(6), if—

(1) The amount specified in paragraph (a)(3)(i) of this section is less than the amount specified in paragraph (a)(3)(ii) of this section; or

(2) The partnership or S corporation terminates its section 444 election, within the meaning of §1.444-1T(a)(5).

(d) *Examples.* The provisions of this section may be illustrated by the following examples.

Example (1). G, a partnership, is owned 10 percent by a C corporation with a June 30 taxable year, and 90 percent by calendar year individuals. G has historically used a June 30 taxable year. For its taxable year beginning July 1, 1987, G makes a section 444 election to retain its June 30 taxable year. For the base year from July 1, 1986 to June 30, 1987, G has net income of $300,000 and no applicable payments. G's deferral ratio is 6/12 (the ratio of the number of months in the deferral period to 12 months). Based on these facts, G's net base year income is $150,000 ($300,000 × 6/12). Thus, G's required payment for its first applicable election year is $13,500 ($150,000 of net base year income multiplied by 9 percent (the product of the applicable percentage for 1987, 25 percent, and the highest section 1 rate for 1987, 36 percent)).

Example (2). The facts are the same as in example (1). In addition, G continues its section 444 election for the taxable year beginning July 1, 1988, and G's net base year income for the year beginning July 1, 1987 is $150,000. The required payment for G's second applicable election year is $8,250 ($150,000 of net base year income multiplied by 14.5 percent (the product of the applicable percentage for 1988 applicable election years, 50 percent, and the adjusted highest section 1 rate for 1988, 29 percent) less G's $13,500 required payment for the first applicable election year).

Example (3). H, a partnership with a taxable year ending September 30, desires to make a section 444 election for its taxable year beginning October 1, 1987. H is 15 percent owned by I, a partnership with a taxable year ending September 30, and 85 percent owned by calendar year individuals. Assume H and I are qualified to make section 444 elections as a result of the "same taxable year exception" provided in §1.444-2T(e). If H and I make section 444 elections, they must each make a required payment (assuming the amount computed under paragraph (a)(3) of this section is greater than $500). Pursuant to paragraph (a)(3) of this section, the required payments of H and I are calculated independent of each other. Thus, in determining the amount of its required payment, I may not exclude its income attributable to H, even though H must also make a required payment on the same income.

Example (4). The facts are the same as in example (1) except that H is 90 percent owned by I and 10 percent owned by calendar year individuals. Pursuant to §1.706-3T, if I makes a section 444 election to retain its taxable year ending September 30, H's required year will be September 30, because H's majority interest partner will have a September 30 taxable year. Thus, H is not required to make a section 444 election and a required payment in order to use a September 30 taxable year. I, however, must make a required payment.

§1.7519-2T Required payments—procedures and administration (temporary).

(a) *Payment and return required*—(1) *In general.* With respect to any taxable year for which a partnership or S corporation has a section 444 election in effect (an "applicable election year"), the partnership or S corporation shall file a return as provided in paragraphs (a)(2) and (3) of this section and make a payment, if required, as provided in paragraph (a)(4) of this section.

(2) *Return required*—(i) *In general.* A return showing the required payment shall be made, even if the required payment for the applicable election year is zero. For an applicable election year beginning in 1987, the return shall be made on Form 720, "Quarterly Federal Excise Tax Return." For an applicable election year beginning after 1987, the return shall also be made on Form 720 unless another form is prescribed by the Commissioner.

(ii) *Procedure if amount for applicable election year (and all preceding years) is not greater than $500.* If a partnership or S corporation is not required to make a payment under section 7519 for an applicable election year, the partnership or S corporation should type or legibly print "zero" on the appropriate line of the prescribed form.

(3) *Time and place for filing return*—(i) *Applicable election years beginning in 1987.* For an applicable election year beginning in 1987, the Form 720 must be filed with the Service Center indicated by the instructions for the Form 720. The date for filing such form is as follows—

(A) *Taxpayers that would otherwise file Form 720 for the second quarter of 1988.* Taxpayers that are required, without regard to this section, to file Form 720 for the second quarter of 1988 (*e.g.*, taxpayers reporting liability for manufacturers excise tax) must file Form 720 by the normal due date of such form for the second quarter of 1988. Thus, such taxpayers must generally file Form 720 on or before July 31, 1988. However, if such taxpayers must also report tax imposed by section 4251 (relating to communications service tax), sections 4261 and 4271 (relating to air transportation tax), or section 4986 (relating to windfall profits tax) for the second quarter of 1988, they must file Form 720 on or before August 31, 1988.

(B) *Other taxpayers.* Taxpayers that are not described in paragraph (a)(3)(i)(A) of this section (*i.e.*, taxpayers that but for this section would not be required to file Form 720 for the second quarter of 1988) must file Form 720 on or before July 31, 1988.

(ii) *Applicable election years beginning after 1987*—(A) *Return made on Form 720.* [Reserved].

(B) *Return made on form other than Form 720.* For an applicable election year beginning after 1987, the return showing the required payment is to be filed with the Service Center indicated by the instructions for the form prescribed for payment. The return must be filed on or before the date prescribed by the instructions to the form.

(iii) *Special rule for back-up section 444 election.* See §1.444-3t(b)(4)(iii) for a special rule that may extend the due date for filing a return required by paragraph (a)(2) of this section.

(4) *Time and place for making required payment*—(i) *Applicable election years beginning in 1987.* For an applicable election year beginning in 1987, the required payment is due and payable without assessment and notice on or before the date the taxpayer's Form 720 for the second quarter is due (as specified in paragraph (a)(3) of this section). The required payment must be paid by check or money order, and such check or money order must indicate the partnership's or S corporation's taxpayer identification number and must include the statement: "IRS NO. 11 PAYMENT." The check or money

order must be sent, together with Form 720, to the Service Center indicated by the instructions for the Form 720.

(ii) *Applicable election years beginning after 1987.* For an applicable election year beginning after 1987, the required payment is due and payable without assessment or notice, on or before May 15 of the calendar year following the calendar year in which the applicable election year begins.

(iii) *Special rule for back-up section 444 election.* See §1.444-3T(b)(4)(iii) for a special rule that may extend the due date for making a required payment.

(5) *Penalties for failure to pay.* In the case of any failure by a partnership of S corporation to pay the required payment on or before the date prescribed in paragraph (a)(4) of this section, there shall be assessed on such partnership or S corporation a penalty of 10 percent of the underpayment. For purposes of this section, the term "underpayment" means the excess of the amount of the payment required under this section over the amount (if any) of such payment paid on or before the date prescribed in paragraph (a)(4) of this section.

(6) *Refund of required payment—*(1) *In general.* If a partnership or S corporation is entitled to make a claim for refund pursuant to §1.7519-1T(c), such partnership or S corporation should file a claim for refund, as provided in paragraph (a)(6)(ii) of this section. However, in no event shall a refund be made prior to April 15 of the second calendar year that follows the calendar year in which an applicable election year begins. For example, assume a partnership made a section 444 election to retain its taxable year for its taxable year beginning October 1, 1987, and as a result made a required payment for such year. Further assume that the partnership terminates its election for its taxable year beginning October 1, 1988. Based on these facts, the partnership will be entitled to a refund, but no earlier than April 15, 1989.

(ii) *Procedures for claiming refund.* [Reserved].

(iii) *Interest on refund.* No interest shall be allowed with respect to any refund of a required payment under §1.7519-1T(c).

(b) *Assessment and collection of payment.* A required payment shall be assessed and collected in the same manner as if it were a tax imposed by subtitle C. Furthermore, no deduction shall be allowable to a partnership or S corporation (or their owners) with respect to the required payment.

(c) *Termination due to willful failure.* See §1.444-1T(a)(5)(i)(C), which provides that willful failure to comply with the requirements of this section will result in the termination of the section 444 election.

(d) *Negligence and fraud penalties made applicable.* For purposes of section 6653, relating to additions to tax for negligence and fraud, any payment required by this section shall be treated as a tax.

§1.7519-3T Effective date (temporary).

The provisions of §§1.7519-1T through §1.7519-3T are effective for taxable years beginning after December 31, 1986.

Par. 4. Section 1.706-3T is added in the appropriate place.

§1.706-3T Temporary regulations under the Tax Reform Act of 1986 and the Revenue Act of 1987 (temporary).

(a) *Certain tax-exempt partners disregarded—(1) General rule.* In determining the taxable year (the "current year") of a partnership under section 706(b) and the regulations thereunder, a partner that is tax-exempt under section 501(a) shall be disregarded if such partner was not subject to tax, under chapter 1 of the Code, on any income attributable to its investment in the partnership during the partnership's taxable year immediately preceding the current year. However, if a partner that is tax-exempt under section 501(a) was not a partner during the partnership's immediately preceding taxable year, such partner will be disregarded for the current year if the partnership reasonably believes that the partner will not be subject to tax, under chapter 1 of the Code, on any income attributable to such partner's investment in the partnership during the current year.

(2) *Example.* The provisions of paragraph (a)(1) of this section may be illustrated by the following example.

Example. Assume that partnership A has historically used the calendar year as its taxable year. In addition, assume that A is owned by 5 partners, 4 calendar year individuals (each owning 10 percent of A's profits and capital) and a tax-exempt organization (owning 60 percent of A's profits and capital). The tax-exempt organization has never had unrelated business taxable income with respect to A and has historically used a June 30 fiscal year. Finally, assume that A desires to retain the calendar year for its taxable year beginning January 1, 1987. Under these facts and but for the special rule in paragraph (a)(1) of this section, A would be required under section 706(b)(1)(B)(i) to change to a year ending June 30, for its taxable year beginning January 1, 1987. However, under the special rule provided in paragraph (a)(1) of this section, and assuming the optional effective date provided in paragraph (c) of this section is chosen, the partner that is tax-exempt is disregarded, and A must retain the calendar year, under section 706(b)(1)(B)(i), for its taxable year beginning January 1, 1987.

(b) *Effect of partner elections under section 444.* For purposes of section 706(b)(1)(B), any section 444 election by a partner in a partnership shall be taken into account in determining the taxable year of the partnership. See example (4) of §1.7519-1T(d).

(c) *Effective date.* The provisions of this section are generally effective for taxable years beginning after December 31, 1987. However, a partnership may, at its option, apply the provisions of this section for taxable years beginning after December 31, 1986.

Par. 5. Section 706-1T is revised by adding a new sentence at the end of paragraph (a)(1) to read as follows:

§1.706-1T Taxable years of certain partnerships (temporary).

(a) ***

(1) *** See §1.706-3T(a) for special rules which provide that certain tax-exempt partners are disregarded.

* * * * *

Par. 6. Sections 1.280H-0T—1.20H-1T are added to Part 1 in the appropriate place.

§1.280H-0T Table of contents (temporary).

This section lists the captions that appear in the temporary regulations under section 280H.

best copy available

§1.280H–1T Limitation on certain amounts paid to employee-owners by personal service corporations electing alternative taxable years (temporary).

(a) Introduction
(b) Limitations on certain deductions of a personal service corporation.
  (1) In general.
  (2) Carryover of nondeductible amounts.
  (3) Disallowance inapplicable for certain purposes.
  (4) Definition of applicable amount.
    (i) In general.
    (ii) Special rule for certain indirect payments.
    (iii) Examples.
(c) Minimum distribution requirement.
  (1) Determination of whether requirement satisfied.
    (i) In general.
    (ii) Employee-owner defined.
  (2) Preceding year test.
    (i) In general.
    (ii) Example.
  (3) 3-year average test.
    (i) In general.
    (ii) Applicable percentage.
    (iii) Adjusted taxable income.
      (A) In general.
      (B) Determination of adjusted taxable income for the deferral period of the applicable election year.
      (C) NOL carryovers.
      (D) Examples.
(d) Maximum deductible amount.
  (1) In general.
  (2) Example.
(e) Special rules and definition.
  (1) Newly organized personal service corporations.
  (2) Existing corporations that become personal service corporations.
  (3) Disallowance of NOL carryback.
  (4) Deferral period.
  (5) Examples.
(f) Effective date.

§1.280H–1T Limitation on certain amounts paid to employee-owners by personal service corporations electing alternative taxable years (temporary).

(a) *Introduction*. This section applies to any taxable year that a personal service corporation has a section 444 election in effect (an "applicable election year"). For purposes of this section, the term "personal service corporation" has the same meaning given such term in §1.441–4T(d).

(b) *Limitation on certain deductions of personal service corporations*—(1) *In general*. If, for any applicable election year, a personal service corporation does not satisfy the minimum distribution requirement in paragraph (c) of this section, the deduction otherwise allowable under chapter 1 of the Internal Revenue Code of 1986 (the Code) for applicable amounts, as defined in paragraph (b)(4) of this section, shall not exceed the maximum deductible amount, as defined in paragraph (d) of this section.

(2) *Carryover of nondeductible amounts*. Any amount not allowed as a deduction in an applicable election year under paragraph (b)(1) of this section shall be allowed as a deduction in the succeeding taxable year.

(3) *Disallowance inapplicable for certain purposes*. The disallowance of deductions under paragraph (b)(1) of this section shall not apply for purposes of subchapter G of chapter 1 of the Code (relating to corporations used to avoid income tax on shareholders) nor for determining whether the compensation of employee-owners is reasonable. Thus, for example, in determining whether a personal service corporation is subject to the accumulated earnings tax imposed by section 531, deductions disallowed under paragraph (b)(1) of this section are treated as allowed in computing accumulated taxable income.

(4) *Definition of applicable amount*—(i) *In general*. For purposes of section 280H and the regulations thereunder, the term "applicable amount" means, with respect to a taxable year, any amount that is otherwise deductible by a personal service corporation in such year and includible at any time, directly or indirectly, in the gross income of a taxpayer that during such year is an employee-owner. Thus, an amount includible in the gross income of an employee-owner will be considered an applicable amount even though such employee owns no stock of the corporation on the date the employee includes the amount in income. See example (1) in paragraph (b)(4)(iii) of this section.

(ii) *Special rule for certain indirect payments*. For purposes of paragraph (b)(4)(i) of this section, amounts are indirectly includible in the gross income of an employee-owner of a personal service corporation that has made a section 444 election (an electing personal service corporation) if the amount is includible in the gross income of—

(A) The spouse (other than a spouse who is legally separated from the partner or shareholder under a decree of divorce or separate maintenance) or child (under age 14) of such employee-owner, or

(B) A corporation more than 50 percent (measured by fair market value) of which is owned in the aggregate by employee-owners (and individuals related under paragraph (b)(4)(ii)(A) of this section to such employee-owners), of the electing personal service corporation, or

(C) A partnership more than 50 percent of the profits and capital of which is owned by employee-owners (and individuals related under paragraph (b)(4)(ii)(A) of this section to such employee-owners) of the electing personal service corporation, or

(D) A trust more than 50 percent of the beneficial ownership of which is owned in the aggregate by employee-owners (and individuals related under paragraph (b)(4)(ii)(A) of this section to any such employee-owners), of the electing personal service corporation.

For purposes of this paragraph (b)(4)(ii), ownership by any person described in this paragraph (b)(4)(ii) shall be treated as ownership by the employee-owners of the electing personal service corporation. Paragraph (b)(4)(ii)(B) of this section will not apply if the corporation has made a section 444 election to use the same taxable year as that of the electing personal service corporation.

Similarly, paragraph (b)(4)(ii)(C) of this section will not apply if the partnership has made a section 444 election to use the same taxable year as that of the electing personal service corporation. Notwithstanding the general effective date provision of paragraph (f) of this section, this paragraph (b)(4)(ii) is effective for amounts deductible on or after June 1, 1988.

(iii) *Examples*. The provisions of paragraph (b)(4) of this section may be illustrated by the following examples.

Example (1). A is an employee of P, an accrual basis personal service corporation with a taxable year ending September 30. P makes a section 444 election for its taxable year beginning October 1, 1987. On October 1, 1987, A owns no stock of P; however, on March 31, 1988, A acquires 10 of the 200 outstanding shares of P stock. During the period October 1, 1987 to March 31, 1988, A earned $40,000 of compensation as an employee of P. During the period April 1, 1988 to September 30, 1988, A earned $60,000 of compensation as an employee-owner of P. If paragraph (b) of this section does not apply, P would deduct for its taxable year ended September 30, 1988 the $100,000 earned by A during such year. Based upon these facts, the $100,000 otherwise deductible amount is considered an applicable amount under this section.

Example (2). I1 and I2, calendar year individuals, are employees of PSC1, a personal service corporation that has historically used a taxable year ending January 31. I1 and I2 also own all the stock, and are employees, of PSC2, a calendar year personal service corporation. For its taxable years beginning February 1, 1987, 1988, and 1989, PSC1 has a section 444 election in effect to use a January 31 taxable year. During its taxable years beginning February 1, 1986, 1987, and 1988, PSC1 deducted $10,000, $11,000, and $12,000, respectively, that was included in PSC2's gross income. Furthermore, of the $12,000 deducted by PSC1 for its taxable year beginning February 1, 1988, $7,000 was deducted during the period June 1, 1988 to January 31, 1989. Pursuant to paragraph (b)(4)(ii)(B) of this section, the $7,000 deducted by PSC1 on or after June 1, 1988, and included in PSC2's gross income is considered an applicable amount for PSC1's taxable year beginning February 1, 1988. Amounts deducted by PSC1 prior to June 1, 1988, are not subject to paragraph (b)(4)(ii)(B) of this section.

Example (3). The facts are the same as in example (2), except that for its taxable years beginning February 1, 1987, 1988, and 1989, PSC2 has a section 444 election in effect to use a January 31 taxable year. Since both PSC1 and PSC2 have the same taxable year and both have section 444 elections in effect, paragraph (b)(4)(ii)(B) of this section does not apply to the $7,000 deducted by PSC1 for its taxable year beginning February 1, 1988.

(c) *Minimum distribution requirement*—(1) *Determination of whether requirement satisfied*—(i) *In general*. A personal service corporation meets the minimum distribution requirement of this paragraph (c) for an applicable election year if, during the deferral period of such taxable year, the applicable amounts (determined without regard to paragraph (b)(2) of this section) for all employee-owners in the aggregate equal or exceed the lesser of—

(A) The amount determined under the "preceding year test" (see paragraph (c)(2) of this section), or

(B) The amount determined under the "3-year average test" (see paragraph (c)(3) of this section).

The following example illustrates the application of this paragraph (c)(1)(i).

Example. Q, an accrual-basis personal service corporation, makes a section 444 election to retain a year ending January 31 for its taxable year beginning February 1, 1987. Q has 4 employee owners, B, C, D, and E. For Q's applicable election year beginning February 1, 1987 and ending January 31, 1988, B earns $6,000 a month plus a $45,000 bonus on January 15, 1988; C earns $5,000 a month plus a $40,000 bonus on January 15, 1988; D and E each earn $4,500 a month plus a $4,000 bonus on January 15, 1988. Q meets the minimum distribution requirement for such applicable election year if the applicable amounts during the deferral period (*i.e.*, $220,000) equal or exceed the amount determined under the preceding year test or the 3-year average test.

(ii) *Employee-owner defined*. For purposes of section 280H and the regulations thereunder, a person is an employee-owner of a corporation for a taxable year if—

(A) On any day of the corporation's taxable year, the person is an employee of the corporation or performs personal services for or on behalf of the corporation, even if the legal form of that person's relationship to the corporation is that of an independent contractor, and

(B) On any day of the corporation's taxable year, the person owns any outstanding stock of the corporation.

(2) *Preceding year test*—(i) *In general*. The amount determined under the preceding year test is the product of—

(A) The applicable amounts during the taxable year preceding the applicable election year (the "preceding taxable year"), divided by the number of months (but not less than one) in the preceding taxable year, multiplied by

(B) The number of months in the deferral period of the applicable election year.

(ii) *Example*. The provisions of paragraph (c)(2) of this section may be illustrated by the following example.

Example. R, a personal service corporation, has historically used a taxable year ending January 31. For its taxable year beginning February 1, 1987, R makes a section 444 election to retain its January 31 taxable year. R is an accrual basis taxpayer and has one employee-owner, F. For R's taxable year ending January 31, 1987, F earns $5,000 a month plus a $40,000 bonus on January 15, 1987. The amount determined under the preceding year test for R's applicable election year beginning February 1, 1987 is $91,667 ($100,000, the applicable amounts during R's taxable year ending January 31, 1987, divided by 12, the number of months in R's taxable year ending January 31, 1987, multiplied by 11, the number of months in R's deferral period for such year).

(3) *3-year average test*—(i) *In general*. The amount determined under the 3-year average test is the applicable percentage multiplied by the adjusted taxable income for the deferral period of the applicable election year.

(ii) *Applicable percentage*. The term "applicable percentage" means the percentage (not in excess of 95 percent) determined by dividing—

(A) The applicable amounts during the 3 taxable years of the corporation (or, if fewer, the taxable years the corporation has been in existence) immediately preceding the applicable election year, by

(B) The adjusted taxable income of such corporation for such 3 taxable years (or, if fewer, the taxable years of existence).

(iii) *Adjusted taxable income*—(A) *In general*. The term "adjusted taxable income" means taxable income determined without regard to applicable amounts.

(B) *Determination of adjusted taxable income for the deferral period of the applicable election year*. Adjusted taxable income for the deferral period of the applicable election year equals the adjusted taxable income that would result if the personal service corporation filed an income tax return for the deferral period of the applicable election year under its normal method of accounting. However, a personal service corporation may make a reasonable estimate of such amount.

(C) *NOL carryovers*. For purposes of determining adjusted taxable income for any period, any NOL carryover shall be reduced by the amount of such carryover that is attributable to the deduction of applicable amounts. The portion of the NOL carryover attributable to the deduction of applicable amounts is the difference between the NOL carryover computed with the deduction of such amounts and the NOL carryover computed without the deduction of such amounts. For purposes of determining the adjusted taxable income for the deferral period, an NOL carryover to the applicable election year, reduced as provided in this paragraph (c)(3)(iii)(C), shall be allowed first against the income of the deferral period.

(D) *Examples*. The provisions of this paragraph (c)(3)(iii) may be illustrated by the following examples.

Example (1). S is a personal service corporation that has historically used a taxable year ending January 31. For its taxable year beginning February 1, 1987, S makes a section 444 election to retain its taxable year ending January 31. S does not satisfy the minimum distribution requirement for its first applicable election year, and the applicable amounts for that year exceed the maximum deductible amount by $54,000. Under paragraph (b)(2) of this section, the $54,000 excess is carried over to S's taxable year beginning February 1, 1988. Furthermore, if S continues its section 444 election for its taxable year beginning February 1, 1988, and desires to use the 3-year average test provided in this paragraph for such year, pursuant to paragraph (c)(3)(iii)(A) of this section the $54,000 will not be allowed to reduce adjusted taxable income for such year. See also section 280H(e) regarding the disallowance of net operating loss carrybacks to (or from) any taxable year if a corporation personal service election under section 444 applies.

Example (2). T, a personal service corporation with a section 444 election in effect, is determining whether it satisfies the 3-year average test for its second applicable election year. T had a net operating loss (NOL) for its first applicable election year of $45,000. The NOL resulted from $150,000 of gross income less the sum of $96,000 of salary, $45,000 of other expenses, and $54,000 of deductible applicable amounts. Pursuant to paragraph (c)(3)(iii)(C) of this section, the entire amount of the $45,000 NOL is attributable to applicable amounts since the applicable amounts deducted in arriving at the NOL (*i.e.*, $54,000) were greater than the NOL (*i.e.*, $45,000). Thus, for purposes of computing the adjusted taxable income for the deferral period of T's second applicable election year, the NOL carryover to that year is $0 ($45,000 NOL less than $45,000 amount of NOL attributable to applicable amounts).

(d) *Maximum deductible amount*—(1) *In general*. For purposes of this section, the term "maximum deductible amount" means the sum of—

(i) The applicable amounts during the deferral period of the applicable election year, plus

(ii) An amount equal to the product of—

(A) The amount determined under paragraph (d)(1)(i) of this section divided by the number of months in the deferral period of the applicable election year, multiplied by

(B) The number of months in the nondeferral period of the applicable election year.

For purposes of the preceding sentence, the term "nondeferral period" means the portion of the applicable election year that occurs after the portion of such year constituting the deferral period.

(2) *Example*. The provisions of paragraph (d)(1) of this section may be illustrated by the following example.

Example. U, an accrual basis personal service corporation with a taxable year ending January 31, makes a section 444 election to retain a year ending January 31 for its taxable year beginning February 1, 1987. For its applicable election year beginning February 1, 1987, U does not satisfy the minimum distribution requirement in paragraph (c) of this section. Furthermore, U has 3 employee-owners, G, H, and I. G and H have been employee-owners of U for 10 years. Although I has been an employee of U for 4 years, I did not become an employee-owner until December 1, 1987, when I acquired 5 of the 20 outstanding shares of U stock. For U's applicable election year beginning February 1, 1987, G earns $5,000 a month plus a $40,000 bonus on January 15, 1988, and H and I each earn $4,000 a month plus a $32,000 bonus on January 15, 1988. Thus, the total of the applicable amounts during the deferral period of the applicable election year beginning February 1, 1987 is $143,000. Based on these facts, U's deduction for applicable amounts is limited to $156,000, determined as follows—$143,000 (applicable amounts during the deferral period) plus $13,000 (applicable amounts during the deferral period, divided by the number of months in the deferral period, multiplied by the number of months in the nondeferral period).

(e) *Special rules and definition*—(1) *Newly organized personal service corporations*. A personal service corporation is deemed to satisfy the preceding year test and the 3-year average test for the first year of the corporation's existence.

(2) *Existing corporations that become personal service corporations*. If an existing corporation becomes a personal service corporation and makes a section 444 election, the determination of whether the corporation satisfies the preceding year test and the 3-year average test is made by treating the corporation as though it were a personal service corporation for each of the 3 years preceding the applicable election year.

(3) *Disallowance of NOL carryback*. No net operating loss carryback shall be allowed to (or from) any applicable election year of a personal service corporation.

(4) *Deferral period*. For purposes of section 280H and the regulations thereunder, the term "deferral period" has the same meaning as under §1.444-1T(b)(4).

(5) *Examples*. The provisions of this paragraph (e) may be illustrated by the following examples.

Example (1). V is a personal service corporation with a taxable year ending September 30. V makes a section 444 election for its taxable year beginning October 1, 1987, and incurs a net operating loss (NOL) for such year. Because a NOL is not allowed to be carried back from an applicable election year, V may not carry back the NOL from its first applicable election year to reduce its 1985, 1986, or 1987 taxable income.

Example (2). W, a personal service corporation, commences operations on July 1, 1990. Furthermore, for its taxable year beginning July 1, 1990, W makes a section 444 election to use a year ending September 30. Pursuant to paragraph (e)(1) of this section, W satisfies the preceding year test and the 3-year average test for its first year in existence. Thus, W may deduct, without limitation under this section, any applicable amounts for its taxable year beginning July 1, 1990.

Example (3). The facts are the same as in example (2). For its taxable year beginning

October 1, 1990, W incurs an NOL and is not a personal service corporation. Furthermore, W desires to carry back the NOL to its preceding taxable year (a year that was an applicable election year). Pursuant to paragraph (e)(3) of this section, W may not carry back a NOL "to" its taxable year beginning July 1, and ending September 30, 1990, because such year was an applicable election year.

(f) *Effective date*. The provisions of this section are effective for taxable years beginning after December 31, 1986.

OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT (26 CFR PART 602)

Par. 7. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 8. Section 602.101(c) is amended by inserting in the appropriate place in the table "§1.444-3T. . .1545-1036."

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impractical to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved May 12, 1988.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on May 24, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 27, 1988, 53 F.R. 19688)

Part II.—Methods of Accounting
Subpart A.—Methods of Accounting in General

Section 448.—Limitation on Use of Cash Method of Accounting

26 CFR 1.448-2T: Nonaccrual of certain amounts by service providers (temporary).

T.D. 8194

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Nonaccrual-experience Method of Accounting

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the nonaccrual-experience method of accounting. The Tax Reform Act of 1986 added the nonaccrual-experience method of accounting to the law. These regulations affect taxpayers using the nonaccrual-experience method of accounting and provide them with guidance needed to comply with the law. The text of the temporary regulations contained in this document also serves as the text of the proposed regulations *** [LR-26-88, page 933, this Bulletin]. DATES: The regulations contained in this document are effective December 31, 1986, and apply to taxable years beginning after such date.

SUPPLEMENTARY INFORMATION

BACKGROUND

This document amends the Temporary Income Tax Regulations (26 CFR Part 1) relating to the nonaccrual-experience method under section 448(d)(5) of the Internal Revenue Code of 1986. Section 801 of the Tax Reform Act of 1986 (the Act) (Pub. L. 99-514, 100 Stat. 2085) added section 448(d)(5) to the Code.

EXPLANATION OF PROVISIONS

Section 448(d)(5) provides that taxpayers who use an accrual method of accounting need not accrue any amounts (accounts receivable) to be received from the performance of services if, on the basis of experience, such amounts will not be collected. On June 16, 1987, the Service published temporary regulations under section 448(d)(5), relating to the nonaccrual-experience method (52 FR 22764, T.D. 8143). Those temporary regulations also served as a notice of proposed rulemaking (52 FR 22796).

Under the nonaccrual-experience method of accounting, the portion of a receivable that is considered uncollectible and not required to be accrued is the product of the receivable and a fraction representing the taxpayer's bad debt experience. The numerator of the fraction is the taxpayer's bad debts for the taxpayer's current and five preceding taxable years, and the denominator of the fraction is the taxpayer's account receivable for the same six-year period. The Internal Revenue Service has received questions from taxpayers as to whether the denominator of the fraction is determined on the basis of (i) total accounts receivable earned throughout the six-year period (i.e., the total amount of sales resulting in accounts receivable throughout the period) or (ii) year-end balances of the accounts receivable over the six-year period. These regulations provide that the denominator is based on total accounts receivable earned throughout the period ending at the close of the six-year period. This interpretation is consistent with the legislative history of the Act which provides that "[t]he amount of billings that, on the basis of experience, will not be collected is equal to the total amount billed, multiplied by a fraction whose numerator is the total amount of such receivables which were billed and determined not to be collectible within the most recent five taxable years of the taxpayer, and whose denominator is the total of such amounts billed within the same five year period." H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 608 (1985). These regulations only apply to the determination of a taxpayer's bad debt experience under section 448. These regulations do not apply to any other provision of law including, for example, computations of a taxpayer's reserve for bad debts under section 585 of the Code.

These regulations are effective for taxable years beginning after December 31, 1986. Nevertheless, a taxpayer will not be liable for the addition to tax under section 6654 or 6655 (relating to failure to pay estimated tax) for an increase in income for the period before May 16, 1988, attributable to the computation of the bad debt experience ratio using accounts receivable earned throughout the period ending at the close of the six-year period, rather than the computation of the ratio using year-end balances of accounts receivable over the six-year period.

REGULATORY FLEXIBILITY ACT

A general notice of proposed rulemaking is not required by 5 U.S.C.

553 for temporary regulations. Accordingly, these temporary regulations are not subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

EXECUTIVE ORDER 12291

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291. Therefore, a regulatory impact analysis is not required.

* * * * *

Adoption of amendments to the regulations

For the reasons set out in the preamble, Title 26, Chapter 1, Subchapter A, Part 1 of the Code of Federal Regulations is amended as set forth below:

Paragraph 1. The authority for Part 1 continues to read as follows:

Authority: 26 U.S.C. 7805.***

Par. 2. Section 1.448-2T is amended by revising the first sentence of paragraph (e)(2)(i), by revising example (1) in paragraph (4), and by adding a new paragraph (5) to read as follows:

§1.448-2T Nonaccrual of certain amounts by service providers (temporary).

* * * * *

(e) ***

(1) ***

(2) *Six-year moving average*—(i) *General rule.* For any taxable year the uncollectible amount of a receivable is the amount of that receivable which bears the same ratio to the account receivable outstanding at the close of the taxable year as (A) the total bad debts (with respect to accounts receivable) sustained throughout the period consisting of the taxable year and the five preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period, bears to (B) the sum of the accounts receivable earned throughout the entire six (or fewer) taxable year period (i.e., the total amount of sales resulting in accounts receivable) throughout the period. ***

* * * * *

(4) *Examples.* ***

Example (1). X is a calendar year service provider that uses an accrual method of accounting with respect to the amounts (accounts receivable) to be received from the provision of services. X does not require the payment of interest or penalties with respect to past due accounts receivable. Assume that under this section, X adopts for taxable year 1987 the nonaccrual-experience method of accounting with respect to its accounts receivable. Further, assume that X's total accounts receivable and bad debt experience for the current and five preceding taxable years is as follows:

Years	Total accounts receivable	Bad debts adjusted for recoveries
1982	$ 30,000	$ 5,700
1983	40,000	7,200
1984	50,000	11,000
1985	60,000	10,200
1986	70,000	14,000
1987	80,000	16,800
	$330,000	$64,900

Thus, the ratio of the bad debts (adjusted for recoveries) for the current and five preceding taxable years to the total accounts received over the same period if 19.67% ($64,900/$330,000). Assume that $49,300 of the total $80,000 of accounts receivable earned throughout the taxable year 1987 are outstanding as of the close of such year. Assume further that the $49,300 of the accounts receivable outstanding as of the close of the tax year 1987 consist of 10 separate accounts receivable. The uncollectible amount of each receivable is 19.67%. The amount of these accounts receivable and the uncollectible amount of each is as follows:

Accounts receivable	Applicable ratio	Uncollectible amount
1. $5,200	.1967	$1,022.84
2. 7,300	.1967	1,435.91
3. 3,200	.1967	629.44
4. 4,300	.1967	845.81
5. 1,700	.1967	334.39
6. 4,000	.1967	786.80
7. 6,300	.1967	1,239,21
8. 8,000	.1967	1,573.60
9. 3,200	.1967	629.44
10. 6,100	.1967	1,199.87
$49,300		$9,697.31

For taxable year 1987, X will not accrue as income $9,697.31 of its accounts receivable of $49,300 outstanding as of the close of the year.

* * * * *

(5) *Special rule for estimated tax.* For purposes of section 6654 or 6655 only (relating to the addition to tax for underpayment of estimated tax), a taxpayer's income does not include eligible income attributable to the period before May 16, 1988. A taxpayer's eligible income is the excess (if any) of—

(i) Income (including the amount of any adjustment required under section 481(a)) computed with a bad debt experience ratio using accounts receivable earned throughout the period ending at the close of the six-year period (or other shorter period) described in paragraph (e)(2)(i) of this section, over

(ii) Income (including the amount of any adjustment required under section 481(a)) computed with a bad debt experience ratio using the year-end balances of accounts receivable over such six-year (or other shorter) period.

* * * * *

There is a need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason it is impracticable to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved April 1, 1988.

Dennis E. Ross,
(Acting) Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 14, 1988, 8:45 a.m., and published in the issue of the Federal Register for April 15, 1988, 53 F.R. 12513)

Subpart C.—Taxable Year for Which Deductions Taken

Section 466.—Qualified Discount Coupons Redeemed After Close of Tax Year

26 CFR 1.466-1: Method of accounting for the redemption cost of qualified discount coupons. (Also Section 481; 1.481-1.)

Qualified discount coupons. Guidance is provided regarding the timing and calculation of the section 481(a) adjustments that occur by virtue of abandoning the method of accounting previously allowed under section 466 of the Code.

Rev. Rul. 88-30

ISSUE

If a taxpayer elected to account for the costs of redeeming discount coupons under former section 466 of the Internal Revenue Code, how should that taxpayer account for the change in method of accounting required as a result of the repeal of section 466 by the Tax Reform Act of 1986?

BACKGROUND

Section 823(a) of the Tax Reform Act of 1986 (the 1986 Act), 1986-3 (Vol. 1) C.B. 290, repealed section 466 of the Code. Section 466 allowed a current deduction for the costs of redeeming qualified discount coupons that were received during a statutory redemption period following the close of the tax year. The "discount coupons" covered by former section 466 were a sales promotion device used to encourage the purchase of a specific product by allowing the purchaser of that product to receive a discount of its purchase price.

As a result of the repeal of section 466 of the Code, for tax years beginning after December 31, 1986, a taxpayer may deduct the costs of redeeming only those discount coupons actually received for redemption during the tax year. If a taxpayer elected to have former section 466 apply to the taxpayer's last tax year beginning before January 1, 1987, then the 1986 Act provides special rules (described below) regarding the required change in method of accounting.

FACTS

Situation 1. Taxpayer *W* corporation files its income tax returns on a calendar year basis and computes taxable income under an accrual method of accounting. *W* issues and redeems discount coupons that qualified for the special accounting treatment provided by former section 466 of the Code.

Starting with its tax year beginning January 1, 1979, *W* elected to account for its coupon redemption costs under former section 466 of the Code. This change from *W*'s previous method of accounting for those costs would have resulted in a net decrease in taxable income under section 481(a) (negative section 481(a) adjustment) for 1979. In accordance with former section 466(e), instead of applying section 481, *W* established a suspense account, the effect of which was to defer indefinitely the full deduction of the transitional adjustment, so long as *W* continued to issue and redeem discount coupons.

In tax years 1979 through 1986, *W* made the adjustments to this suspense account, and the corresponding adjustments to income, required by former section 466(e) of the Code and section 1.466-1(e)(3) of the Income Tax Regulations. The closing balance in the suspense account as of December 31, 1986, was 10*x* dollars.

As a result of the 1986 Act's repeal of section 466 of the Code, starting with *W*'s tax year beginning January 1, 1987, the only redemption costs that *W* may deduct are those related to coupons actually received during the tax year. Under former section 466, however, *W* had already deducted, for its 1986 tax year, costs related to coupons received during the first half of 1987. In order to prevent the same costs from reducing *W*'s taxable income twice, section 481(a) requires an adjustment to income for the year of change, 1987. In *W*'s case, this adjustment resulted in a net increase in taxable income (positive section 481(a) adjustment) of 30*x* dollars (not counting the 10*x* dollar balance in *W*'s suspense account). Less than 75 percent of this 30*x* dollar adjustment was attributable to the 1-, 2-, or 3-tax-year period immediately preceding the year of change.

Situation 2. The facts are the same as in *Situation 1*, except that taxpayer *X* first elected to use the method provided by former section 466 of the Code for its tax year beginning January 1, 1985.

Situation 3. The facts are the same as in *Situation 1*, except that the highest percentage of taxpayer *Y*'s 30*x* dollar 1987 positive section 481(a) adjustment that was attributable to the 1-, 2-, or 3-tax-year period immediately preceding 1987 was 90 percent.

Situation 4. The facts are the same as in *Situation 1*, except that, under section 481(a) of the Code, taxpayer *Z*'s 1979 election to use the accounting method provided by section 466 resulted in a 20*x* dollar net increase in taxable income for 1979. Because this net section 481(a) adjustment was positive, *Z* did not establish a suspense account. Instead, in accordance with former section 466(f), *Z* took one-tenth of this positive adjustment into income in each of the years 1979 through 1986, leaving an unamortized balance of 4*x* dollars as of January 1, 1987. Thus, of the 10-year period over which the section 481(a) adjustment resulting from the initial election was to be spread under section 466(f), 2 years remained when *Z* was required to change its method of accounting as a result of the repeal of section 466.

LAW

Prior to its repeal, section 466(a) of the Code provided for an election by an accrual basis taxpayer to deduct costs incurred by the taxpayer with respect to the redemption of qualified discount coupons that were outstanding at the close of the tax year and that were received by the taxpayer within up to a 6-month period following the close of the tax year. The taxpayer also deducted the costs of coupons actually redeemed during the tax year to the extent those costs were not already deducted in an earlier year. The election applied to all qualified coupons issued in connection with the trade or business with respect to which the taxpayer made the election.

An election to use the method provided by former section 466 of the Code constituted a change in method of accounting. The statute provided that the section 481(a) adjustment caused by the election was to be taken into account under one of two specified methods, depending on whether the net adjustment was negative or positive.

First, former section 466(e) of the Code provided that, in the case of any election under section 466 that (but for section 466(e)) would result in a net decrease in taxable income under section 481(a)(2), the taxpayer, in lieu of applying section 481, had to establish a suspense account for the trade or business for the tax year (year of change) for which the election was made. The initial opening balance of the suspense account for the year of change was the amount by which (A) the largest dollar amount that would have been taken into account for any of the 3 immediately preceding tax years, if section 466 had applied to those years, exceeded (B) the sum of the increases in income (and the decreases in deductions) which (but for section 466(e)) would have resulted under section 481(a)(2) for the year of change. At the close of each year, the suspense account was either (A) reduced by the excess (if any) of (i) the opening balance of the suspense account for the year over (ii) the amount deducted for the year under section 466(a), or (B) increased (but not in excess of the initial opening balance) by the excess (if any) of (i) the amount deducted under section 466(a) over (ii) the opening balance in the suspense account for the year. In the case of any reduction or increase in the suspense account, an amount equal to the reduction was allowed as a deduction for the year, or an amount equal to the increase was included in gross income.

Second, former section 466(f) of the Code provided that, in the case of any election under section 466 that resulted in a net increase in taxable income under section 481(a)(2), the increase was to be taken into account by the taxpayer in computing taxable income in each of the 10 tax years beginning with the year of change, in accordance with regulations. Section 1.466-1(e)(2) of the regulations provided for such a positive adjustment to be taken into income ratably over the 10-year period.

Section 481(a) of the Code provides that in computing taxable income for any taxable year, if the computation is under a method of accounting different from the method under which taxable income for the preceding tax year was computed, then there shall be taken into account those adjustments that are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted.

Section 823(c)(2) of the 1986 Act provides that, in the case of any taxpayer that elected to have former section 466 of the Code apply for the taxpayer's last tax year beginning before January 1, 1987, and that is required to change its method of accounting by reason of the amendments made by section 823 for any tax year, the change shall be treated as initiated by the taxpayer and as having been made with the consent of the Secretary. Under section 823(c)(2)(C), the net amount of adjustments required by section 481 of the Code to be taken into account by the taxpayer shall be reduced by the balance in the suspense account under former section 466(e) as of the close of the last tax year beginning before January 1, 1987, and shall be taken into account over a period not longer than 4 years.

According to the Report of the Senate Committee on Finance, the concepts of Rev. Proc. 84-74, 1984-2 C.B. 736, were expected generally to apply to determine the actual timing of recognition of income or expense as a result of the adjustments arising from section 823 of the 1986 Act. *See* S. Rep. No. 313, 99th Cong., 2d Sess. 159 (1986), 1986-3 (Vol. 3) C.B. 159. In addition, the Report of the Committee of Conference expressed the conferees' intention that (1) net operating loss and tax credit carryforwards be allowed to offset any positive section 481 adjustment, and (2) for the purpose of determining estimated tax payments, the section 481 adjustment be recognized in taxable income ratably throughout the tax year in question. *See* 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-322 (1986), 1986-3 (Vol. 4) C.B. 322.

Section 5.06 of Rev. Proc. 84-74 describes the appropriate period for taking into account an adjustment, whether positive or negative, required by section 481(a) of the Code as a result of a change in methods of accounting. Sections 6.02 and .03 divided methods of accounting into "Category A" and "Category B." Because Category A includes only methods whose use is clearly erroneous, the method authorized by former section 466 was a Category B method. Generally, under section 5.06(1)(e), the total net adjustment attributable to a change from a Category B method is to be taken into account ratably over the number of tax years (not to exceed 6) the taxpayer has used the method of accounting that is being changed. Under section 5.06(1)(a), however, when the entire net amount of the adjustment is attributable to the tax year immediately preceding the year of change, the adjustment is taken into account in the year of change. Under section 5.06(1)(b), if the method has been used for more than 3 years, and section 5.06(1)(a) does not apply, but 67 percent or more of the net amount of the adjustment is attributable to the 1-, 2-, or 3-tax-year period immediately preceding the year of change, then the highest percent attributable to the 1-, 2-, or 3-tax-year period is taken into account ratably over a 3-tax-year period beginning with the year of change, with any remaining balance taken into account ratably over the remainder of the number of years the taxpayer used the method (or 3 years, whichever is less). When the method of accounting being changed has been used for 4 years, 75 percent rather than 67 percent is used in applying section 5.06(1)(b). For purposes of 5.06(1)(a) and (1)(b), the amount of the adjustment that is attributable to a given period is the difference between the amount of the adjustment determined under section 481(a) for the year of change and the amount that would have been required under section 481(a) had the same change been made at the beginning of the period in question.

ANALYSIS

In *Situation 1*, *W*'s change from accounting for coupon redemption costs under section 466 of the Code results in a net positive section 481(a) adjustment of 30*x* dollars for 1987, the year of change. *W* also has an opening balance of 10*x* dollars for 1987 in the section 466(e) suspense account that *W* was required to establish when it elected to use the section 466 method in 1979. *W* is not allowed to deduct an amount equal to the full suspense account balance in the year of change. Instead, under section 823(c)(2)(C) of the 1986 Act, the suspense account balance must be netted against the positive net section 481(a) adjustment. The resulting balance of 20*x* dollars is to be recognized over a period that is determined by applying the concepts of Rev. Proc. 84-74.

In this situation, section 5.06(1)(e) of Rev. Proc. 84-74 would normally call for recognition of the adjustment ratably over a 6-year period beginning in the year of change (here, 1987), because *W* used the section 466 method for 8 years. Under section 823(c)(2)(C) of the 1986 Act, however, the total adjustment period may not exceed 4 years. Accordingly, the net section 481(a) adjustment, after reduction by the suspense account balance, must be taken into income ratably over a 4-year period beginning in 1987.

In *Situation 2*, as in *Situation 1*, *X* must first net the balance in its section 466(e) suspense account against the positive section 481(a) adjustment, resulting in a net balance of 20*x* dollars. In this case, however, *X* has used the method described in former section 466 of the Code for only 2 years. In requiring that the adjustment be taken into account over a period not longer than 4 years, the 1986 Act and the accompanying legislative history suggest that a shorter adjustment period may be appropriate. Consistent with section 5.05(i)(e) of Rev. Proc. 84-74, therefore, the positive section 481(a) adjustment, after reduction for the amount in the suspense account, must be taken into account in two equal portions in *X*'s tax years 1987 and 1988.

Situation 3 differs from *Situation 1* in that a high percentage of *Y*'s positive section 481(a) adjustment for 1987 is attributable to the period immediately preceding the year of change. In such situations, Rev. Proc. 84-74 requires the acceleration of all or a portion of the adjustment that would otherwise be taken into account ratably over the total adjustment period. For example, under section 5.06(1)(a) of Rev. Proc. 84-74, when the entire net amount of the adjustment is attributable to the year immediately preceding the year of change, the full adjustment is taken into account in the year of change. If, as in *Situation 3*, that is not the case but at least a certain percent or more of the adjustment is attributable to the 1-, 2-, or 3-tax-year period preceding the year of change, then under section 5.06(1)(b) an amount equal to the highest such percent is taken into account ratably over a 3-year period. The balance is taken into account ratably over a period equal to the remaining number of years the taxpayer previously used the method being changed, or 3 years, whichever is shorter. (The total adjustment period thus cannot exceed 6 years.) The threshold percentage used in applying section 5.06(1)(b) is 67 percent if the method being changed was used for more than 4 years, and 75 percent if the method was used for 4 years.

Section 5.06(1)(b) of Rev. Proc. 84-74 would apply only to a taxpayer that has used the section 466 method for 4 years or more prior to the year of change. Under Rev. Proc. 84-74, the relevant threshold percentage for a taxpayer that has used the accounting method being changed for more than 4 years is 67 percent. However, a taxpayer that has used a method for 4 years, and is therefore limited to a total adjustment period of 4 years, must accelerate a portion of the adjustment if the amount of the adjustment attributable to the 1-, 2-, or 3-tax-year period preceding the year of change is 75 percent or more. Use of 75 percent rather than 67 percent in the case of a 4-year adjustment period prevents section 5.06(1)(b) from deferring, rather than accelerating, a portion of the adjustment. Under section 823(c)(2)(C)(ii) of the 1986 Act, every taxpayer making the change from the use of section 466 is limited to a 4-year adjustment period, even if the method was used for more than 4 years. In order to be consistent with the concepts of Rev. Proc. 84-74, section 5.06(1)(b) must be applied only in a way that accelerates recognition of part of the adjustment. Accordingly, even if a taxpayer employed the section 466 method for more than 4 years prior to the year of change, that taxpayer must apply section 5.06(1)(b) by using a 75 percent threshold.

In *Situation 3*, *Y* used the method provided by former section 466 of the Code for 8 years prior to repeal. The highest percent of *Y*'s adjustment attributable to the 1-, 2-, or 3-tax-year period preceding 1987 was 90 percent. Because this is more than 75 percent, *Y* must, after netting its suspense account balance against the positive 1987 section 481(a) adjustment, include 30 percent of the resulting balance in income in each of the years 1987 through 1989 and must include the remaining 10 percent in income in 1990.

Unlike the first three situations, *Situation 4* involves a taxpayer whose original election to account for coupon redemption costs under former section 466 of the Code resulted in a net positive section 481(a) adjustment. *Z* has been including one-tenth of this adjustment in income each year since the election.

There is no explicit guidance in either the 1986 Act or its legislative history concerning the proper treatment of the unamortized portion of such an adjustment. Former sections 466(e) and 466(f) of the Code provided for the treatment of negative and positive adjustments, respectively. Section 823 of the 1986 Act, in repealing section 466, specified a method of handling suspense account balances, and that method differed from the method set out in section 466(e). There is no evidence, however, of any intent to change the original 10-year adjustment period that was provided for positive adjustments by former section 466(f). Accordingly, taxpayers must continue to amortize such adjustments over the remainder of that 10-year period.

In *Situation 4*, *Z* used the accounting method to be changed for more than 4 years. Under section 823(c)(2)(C) of the 1986 Act, in each of the years 1987 through 1990 *Z* must taken into account one-fourth of the 1987 section 481(a) adjustment resulting from the repeal of section 466 of the Code. In addition, the unamortized portion of *Z*'s original 1979 adjustment is taken into income in 1987 and 1988.

HOLDING

Taxpayers that previously accounted for discount coupon redemption costs under the method described in former section 466 of the Code must account for the section 481(a) adjustment required by the repeal of that provision over a period of up to 4 years starting with the first tax year beginning after December 31, 1986. They must apply the concepts of Rev. Proc. 84-74, as set forth in this ruling, to determine the actual timing of recognition of income or expense. Any suspense account balance resulting from a taxpayer's prior election to use section 466 must be netted with the adjustment that results from the repeal of section 466. The balance of a previous positive section 481(a) adjustment continues to be amortized over the period originally prescribed.

Specifically, in *Situation 1*, *W* must reduce the net positive section 481(a) adjustment of 30*x* dollars by the 10*x* dollar balance in its suspense account and take one-fourth of the resulting amount, or 5*x* dollars, into income in each of its tax years 1987 through 1990.

In *Situation 2*, *X* must reduce the net positive section 481(a) adjustment of 30*x* dollars by the 10*x* dollar balance in its suspense account and take one-half of the resulting amount, or $10x$ dollars, into income in 1987 and one-half in 1988.

In *Situation 3*, *Y* must first reduce the net positive section 481(a) adjustment of $30x$ dollars by the $10x$ dollar balance in its suspense account; 90 percent of the resulting $20x$ dollars, or $18x$ dollars, must be recognized in three equal portions of $6x$ dollars over the period 1987 through 1989. The remaining $2x$ dollars is taken into income in 1990.

In *Situation 4*, *Z* must take into income the unamortized portion of the previous positive section 481(a) adjustment, or $4x$ dollars, in two equal portions of $2x$ dollars in 1987 and 1988. *Z* must take the net positive section 481(a) adjustment of $30x$ dollars arising in the year of change into income in four equal increments of $7.5x$ dollars in 1987 through 1990.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1988. See Rev. Rul. 88-1, page 307.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1988. See Rev. Rul. 88-9, page 307.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 1988. See Rev. Rul. 88-15, page 308.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1988. See Rev. Rul. 88-22, page 309.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 1988. See Rev. Rul. 88-28, page 310.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 1988. See Rev. Rul. 88-44, page 312.

Section 468.—Special Rules for Mining and Solid Waste Reclamation Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1988. See Rev. Rul. 88-1, page 307.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1988. See Rev. Rul. 88-9, page 307.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 1988. See Rev. Rul. 88-15, page 308.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1988. See Rev. Rul. 88-22, page 309.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 1988. See Rev. Rul. 88-28, page 310.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 1988. See Rev. Rul. 88-44, page 312.

Section 469.—Passive Activity Losses and Credits Limited

26 CFR 1.469-1T: General rules (temporary).

T.D. 8175

TITLE 26—INTERNAL REVENUE—CHAPTER I, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Limitations on Passive Activity Losses and Credits

SUMMARY: This document contains temporary regulations relating to the limitations on passive activity losses and passive activity credits. Changes to the applicable tax law were made by the Tax Reform Act of 1986. The temporary regulations affect taxpayers subject to the limitations on passive activity losses and passive activity credits and provide them with the guidance needed to comply with the law. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations for the notice of proposed rulemaking *** [page 932, this Bulletin].

EFFECTIVE DATE: Except as otherwise provided in § 1.469-11T, the temporary regulations are effective for taxable years beginning after December 31, 1986.

SUPPLEMENTARY INFORMATION:

Background

This document amends the Income Tax Regulations (26 CFR Part 1) to provide temporary rules relating to the limitations on passive activity losses and passive activity credits (the "passive loss and credit limitations"). The temporary regulations reflect the amendment of the Internal Revenue Code of 1986 (the "Code") by sections 501 and 502 of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2233 and 2241), which added section 469. Section 469 disallows the passive activity loss and the passive activity credit for the taxable year.

Scope of the Regulations

These regulations provide general rules for applying the the passive loss and credit limitations.

Section 1.469-1T contains rules relating to the disallowance of the passive activity loss and passive activity credit, the taxpayers to whom the passive loss and credit limitations apply, the general effect of section 469 on the treatment of items of income, gain, loss, deduction, and credit from passive activities, definitions of essential terms (including "passive activity," "trade or business activity," and "rental activity"), the treatment of certain losses from oil and gas working interests, the application of the passive loss and credit limitations to C corporations (including rules relating to the application of the material participation standard, the computation of net active income, and the application of section 469 to affiliated groups of corporations filing consolidated returns), and the treatment of spouses filing joint returns.

Section 1.469-2T contains rules for computing the passive activity loss, including rules for identifying passive activity gross income, passive activity deductions, and portfolio income and related deductions, and rules (including rules pursuant to section 469 (l), (2), and (3)) requiring that income from certain passive activities be treated as income that is not from a passive activity.

Section 1.469-3T contains rules for computing the passive activity credit, including rules relating to the identification of credits subject to section 469 and the computation of the regular tax liability allocable to passive activities.

Section 1.469-5T contains rules defining the term "material participation" for purposes of section 469 and the regulations thereunder.

Section 1.469-11T explains the effective date of section 469 and the regulations thereunder and provides guidance under the transitional rule for losses and credits from preenactment interests in passive activities.

Future regulations will provide rules identifying economic undertakings that are treated as separate activities for purposes of section 469 and the regulations thereunder (to be located in § 1.469-4T), rules relating to the treatment of losses allowable under section 469(g) upon certain dispositions of interests in activities (to be located in § 1.469-6T), rules relating to the treatment of certain "self-charged" expenses and related income (to be located in § 1.469-7T), rules relating to the application of section 469 to trusts, estates, and their beneficiaries (to be located in § 1.469-8T), rules relating to the application of the $25,000 allowance under section 469 (i) for passive activity losses and credits attributable to certain rental real estate activities (to be located in § 1.469-9T), rules relating to the treatment of publicly traded partnerships under section 469(k) (to be located in § 1.469-10T), and rules relating to the application of the passive loss and credit limitations in the case of former passive activities and corporations that change status from year to year, i.e., corporations that cease to be "personal service corporations," corporations that cease to be "closely held corporations," and C corporations that become S corporations (to be located in § 1.469-1T (k)).

Significant Policy Issues

I. Effect of Section 469 on Other Provisions

A. Items of Income or Gain

Section § 1.469-1T(d)(1) provides that the characterization of items of income or deduction as passive activity gross income or passive activity deductions does not affect the treatment of any item of income or gain under any provision of the Code other than section 469. Thus, for example, an item of capital gain from a passive activity that is treated under the regulations as an item of passive activity gross income is taken into account in determining both the passive activity loss and credit for the taxable year and the allowable capital loss for the taxable year.

B. Items of Deduction

Section 1.469-1T(d)(3) provides that, except as otherwise provided by regulations, a deduction that is disallowed for a taxable year under section 469 is not taken into account as a deduction that is allowed for the taxable year in computing the amount subject to any tax imposed by subtitle A of the Code. Thus, for example, if a deduction is disallowed under section 469 for purposes of computing taxable income subject to income tax, the deduction is not taken into account in computing the taxpayer's net earnings from self-employment for purposes of the tax on self-employment income imposed under chapter 2 of the Code.

II. Definition of Passive Activity

A. Trade or Business Activity

Under section 469(c)(1), an activity which involves the conduct of a trade or business and in which the taxpayer does not materially participate is a passive activity. Section 1.469-1T(e)(2) generally defines the term "trade or business activity" to mean an activity that involves the conduct of a trade or business within the meaning of section 162.

Under section 469(c)(6), the term "trade or business" may include, to the extent provided in regulations, any activity in connection with a trade or business, and any activity with respect to which expenses are allowable as a deduction with respect to which expenses are allowable as a deduction under section 212. Although the Service is studying the possibility of treating certain activities in connection with a trade or business and certain section 212 activities as trade or business activities for purposes of section 469, these regulations do not so treat any such activities.

B. Rental Activity

Section 469(j)(8) provides that the term "rental activity" means any activity where payments are principally for the use of tangible property. Section 1.469-1T(e)(3)(i) provides that an activity generally is a rental activity for a taxable year if the gross income attributable to the conduct of the activity for the year represents amounts paid or to be paid principally for the use of tangible property. In addition, an activity may be a rental activity if tangible property in the activity is held for rent and the expected gross income from the activity will represent payments principally for the use of such property.

Section 1.469-1T(e)(3)(ii) provides six exceptions to the general rule. The first exception provides that an activity involving the use of tangible property is not a rental activity if, on the average, the period for which each customer uses the property is seven days or less. This exception will exclude from treatment as a "rental activity" most activities involving short-term use of tangible personal property such as automobiles, videocassettes, tuxedos, and tools, and short-term use of hotel and motel rooms. The rationale for the "seven-day rule" is that a customer's use of property for seven days or less generally will require the person furnishing the property to provide services significant enough to justify the conclusion that the person is engaged in a service business rather than a rental activity.

The second exception provides that an activity involving the use of tangible property is not a rental activity if (a) on the average, the period for which each customer uses the property is greater than seven days but not greater than 30 days and (b) significant personal services are provided. Thus, for example, a taxpayer operating a hotel will not be treated as engaged in a rental activity, even if guests stay for an average period that exceeds seven days, if significant personal services are provided.

Section 1.469-1T(e)(3)(iv) provides that only services performed by individuals are treated as personal services. Thus, services such as telephone and cable television service are not taken into account. Section 1.469-1T(e)(3)(iv)(B) also provides that certain specified services, referred to as "excluded services" are not taken into account. The excluded services are (a) all services necessary to permit the lawful use of the property, (b) services in connection with the construction of improvements or in connection with the performance of repairs that extend the useful life of the property, and (c) in the case of improved real property, the kinds of services commonly provided in connection with long-term rentals of high-grade commercial and residential property (e.g., janitorial services).

The third exception provides that an activity involving the use of tangible property is not a rental activity if extraordinary personal services are provided by or on behalf of the owner in connection with making property available for use by customers. This exception applies even if, on the average, the period for which each customer uses the property exceeds 30 days. Extraordinary personal services are provided only if the services are performed by individuals, and the customers' use of the property is incidental to their receipt of the services provided. For example, the use by patients of a hospital's boarding facilities generally is incidental to their receipt of the personal services provided by the hospital's medical and nursing staff. In some cases, it may be difficult to determine whether the use of property is incidental to the services provided. The Service invites comment on the extraordinary services rule.

The fourth exception is for rentals incidental to certain nonrental activities of the taxpayer. This exception applies if (a) an insubstantial amount of rental income is derived from renting property incidental to an activity of holding such property for investment, (b) the rented property is lodging provided to the taxpayer's employees for the convenience of the taxpayer, (c) an insubstantial amount of rental income is derived from property that was recently used in a trade or business activity of the taxpayer and is temporarily rented, (d) the property is held for sale to customers in the ordinary course of a trade or business and is in fact sold during the taxable year.

The fifth exception provides that an activity of making property available for use by customers is not a rental activity if the taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers. Thus, operating a facility (such as a golf course) that is used by customers who would normally be characterized as invitees or licensees rather than lessees or tenants is not a rental activity.

The sixth exception relates to property provided for use in a nonrental activity of a partnership, S corporation, or joint venture in which the taxpayer owns an interest. The provision of such property is not a rental activity if the taxpayer does not rent the property to the partnership, S corporation or joint venture, but provides the property in the taxpayer's capacity as an owner of such an interest.

III. Special Rules Treating Certain Activities as Nonpassive

A. Exception for Certain Oil and Gas Working Interests

1. *Property unit to which exception applies.* Section 469(c)(3)(A) provides that the term "passive activity" does not include any working interest in any oil or gas property which the taxpayer holds directly or through an entity which does not limit the taxpayer's liability with respect to such interest. Section 1.469-1T(e)(4)((i) applies this rule on a well-by-well basis. Thus, if a taxpayer owns a working interest in a tract of land, assigns the working interest in part of the tract to a partnership in exchange for a limited partnership interest, and drills a well on the retained portion of the tract, the working interest exception will apply to that well. If, however, the partnership drills a well on the assigned portion of the tract, the working interest exception will not apply to the taxpayer's interest in that well.

2. *Entities that limit liability.* Section 1.469-1T(e)(4)(v) provides that an entity limits the liability of a holder of an interest in the entity only if, under the applicable State law, the holder's potential liability for all obligations of the entity is limited (as in the case of a limited partner or a stockholder) to a determinable fixed amount. Thus, the working interest exception may apply even if the taxpayer is protected against loss by an indemnification agreement, a stop loss arrangement, insurance, any similar arrangement, or any combination of such devices.

In addition, a partnership in which a taxpayer is a general partner is treated as an entity that does not limit the taxpayer's liability, and any working interest that the taxpayer holds through such a partnership is treated as an interest in an activity that is not a passive activity. Thus, deductions from the working interest (including deductions allocable to a limited partnership interest of the taxpayer) will not be subject to the passive loss limitation.

Taxpayers should draw no inferences from these rules concerning the application of section 465(b)(4). If deductions and losses from a working interest are subject to limitation under section 465, then the provisions of section 465(b)(4) apply without regard to the treatment of such deductions and losses under section 469. As explained below, the regulations include rules coordinating the limitations under sections 465 and 469.

3. *Effect of limited liability at the time economic performance occurs.* Under § 1.469-1T(e)(4)(i), the working interest exception applies for a taxable year to an interest in an oil or gas well drilled or operated pursuant to a working interest that the taxpayer holds at any time during such year either directly or through an entity that does not limit the liability of the taxpayer with respect to such well. Section 1.469-1T(e)(4)(ii) provides that notwithstanding the working interest exception a portion of the taxpayer's deductions from an oil or gas well will be treated as passive activity deductions (and a corresponding portion of any gross income from the well will be treated as passive activity gross income) if the taxpayer has a net loss from the well, and economic performance occurs with respect to expenses deducted for the taxable year in connection with the drilling or operation of the well at a time when the taxpayer holds the interest in the

well through an entity that limits the taxpayer's liability with respect to such drilling or operation. For this purpose, the term "economic performance" has the same meaning as in section 461(h), without regard to the exceptions for recurring items or the spudding of oil and gas wells.

Under this rule, the working interest exception may apply for a taxable year to a well drilled by a partnership in which the taxpayer owns a general partnership interest that is convertible at the taxpayer's option into a limited partnership interest. If, however, the interest is converted before economic performance has occurred with respect to all items of deduction taken into account by the taxpayer for the taxable year in connection with the drilling or operation of the well, the working interest exception will not apply for the taxable year to that portion of the taxpayer's net loss for the year that is attributable to deductions for expenses with respect to which economic performance occurred after the conversion.

4. *Income recharacterization rule.* If any loss for a taxable year from an interest in an oil or gas property is treated under the working interest exception as a loss that is not from a passive activity, then any net income from the property for any subsequent taxable year is treated as income that is not from a passive activity. This rule is explained more fully below under the heading "Income from oil or gas properties with respect to which the taxpayer benefited from the working interest exception."

B. Trading Personal Property

In some circumstances, the activity of trading personal property (such as securities or commodities or other property of a type that is actively traded) for one's own account has been treated as a trade or business. Even in those circumstances, however, the income or loss from the activity resembles portfolio income or loss in that it results entirely from the holding and sale of personal property. Accordingly, § 1.469-1T(e)(6) provides that an activity of trading personal property of a type that is actively traded for the account of owners of interests in the activity is not a passive activity even if the activity is treated as a trade or business.

IV. Identification of Items of Deduction and Credit That Are Disallowed Under Section 469

Section 1.469-1T(f) provides rules identifying the items of deduction and credit that are disallowed when any part of the taxpayer's passive activity loss or passive activity credit is disallowed for the taxable year. In the case of losses, the regulations generally provide that the amount of the disallowed loss is first allocated ratably among all of the taxpayer's passive activities that have net losses for the year. Any loss allocated to an activity is then generally allocated ratably among all passive activity deductions from the activity for the year. In the case of credits, the first step is omitted; the disallowed passive activity credit is allocated ratably among all of the taxpayer's credits from passive activities.

Taxpayers generally need not account separately for each item of deduction or credit disallowed under section 469. The regulations provide that separate accounting is required if and only if separate identification of an item of deduction or credit may affect the taxpayer's tax liability for any taxable year. For example, if 40 percent of the loss from a passive activity is disallowed for the taxable year, and one of the deductions from the activity is a loss from the sale of a capital asset, the taxpayer must separately identify 40 percent of that deduction as a deduction that is disallowed for the taxable year. Separate identification of the capital loss is required because the limitation on capital losses under section 1211 applies after section 469 and, thus, the disallowance of a capital loss (rather than an ordinary deduction) may affect the taxpayer's tax liability for one or more taxable years.

V. Application of Section 469 to C Corporations

A. Definition of "Personal Service Corporation"

For purposes of section 469, § 1.469-1T(g)(2)(i) defines the term "personal service corporation" by cross reference to the definition of such a corporation in § 1.441-4T(d). Those regulations generally provide that a corporation is not a personal service corporation unless it is a C corporation and its principal activity is the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

B. Effect of Net Active Income of a Closely Held Corporation

Section 469(e)(2)(A) provides that the passive activity loss of a closely held corporation shall be allowable as a deduction against the net active income of such a corporation, and that a similar rule shall apply in the case of any passive activity credit of such a taxpayer. Section 1.469-1T(g)(4) provides that a closely held corporation's passive activity loss for the taxable year is decreased by the corporation's net active income for the year.

Section 1.469-1T(g)(5) provides that a closely held corporation's passive activity credit for the taxable year is decreased by the corporation's net active income tax liability for the year. For purposes of this rule, a closely-held corporation's net active income tax liability is the regular tax liability that is allocable to the corporation's net active income, reduced by all credits other than credits from passive activities.

Since net active income is computed by modifying taxable income, net operating loss carrybacks and carryforwards to the taxable year must be taken into account. Therefore, a net operating loss carryback which requires a closely held corporation to recompute its net active income and net active income tax liability for one or more years may also require a recomputation of the corporation's passive activity loss and passive activity credit for one or more years.

C. Treatment of Affiliated Groups of Corporations Filing Consolidated Returns

Section 1.469-1T(h) contains special rules for applying section 469 and the regulations thereunder to an affiliated group of corporations filing a consolidated return for the taxable year (a "consolidated group"). Under these rules, a consolidated group generally is treated as a single corporation for purposes of section 469 and the regulations thereunder. Thus, a single passive activity loss and passive activity credit are computed for such a group. In addition, the status of each member of an affiliated group as a personal service corporation or closely held corporation is the same as the status of the entire consolidated group, determined as though the group were a single corporation. In making this determination, and in applying the participation tests set forth in § 1.469-1T(g)(3), only stockholders of the group's common parent are treated as stockholders of the hypothetical single corporation.

Section 1.469-1T(h)(5) contains rules for allocating a consolidated group's disallowed passive activity loss and credit among the group's members. Under these rules, the disallowed loss or credit is first allocated among the members of the group and is then allocated among the activities of the members under the general rules in § 1.469-1T(f).

Section 1.469-1T(h)(6) contains rules relating to intercompany transactions (within the meaning of § 1.1502-13(a)(1)). These rules generally are intended to attribute all items of income and deduction of all members that are attributable to an intercompany transaction to the activities of the purchasing member (within the meaning of § 1.1502-13(a)).

The Service invites comment on all aspects of the rules in § 1.469-1T(h).

D. Coordination With Other Provisions

The Service recognizes that further rules are needed to coordinate section 469 with certain other provisions applicable to corporations (e.g., sections 381, 382, and 1502) and invites comment on these rules.

VI. Treatment of Spouses Filing a Joint Return

Section 469(h)(5) provides that in determining whether a taxpayer materially participates in an activity, the participation of the taxpayer's spouse shall be taken into account. Section 469(i)(6)(D) provides a parallel rule for active participation. Section 469(1)(5) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out provisions of section 469, including regulations relating to changes in marital status and changes between joint returns and separate returns.

The Service believes that treating married persons filing a joint return as separate taxpayers for purposes of section 469 would present undesirable administrative difficulties, and that it is generally preferable to treat such persons as one taxpayer. In some situations, however, this treatment would frustrate the purposes of the passive loss and credit limitations. For example, the fact that one spouse holds a working interest in an oil or gas well through an entity that does not limit the spouse's liability should not be taken into account in determining whether the working interest exception applies to any portion of the working interest that is held by the other spouse. In addition, if two individuals cease filing a joint return, it is necessary for each individual to account for the deductions and credits treated under section 469(b) as allocable to his or her passive activities.

Accordingly, § 1.469-1T(j) provides that spouses filing a joint return for a taxable year generally are treated for such year as one taxpayer for purposes of section 469 and the regulations thereunder. For purposes of the working interest exception, however, married persons are treated as separate taxpayers. In addition, if any deductions or credits are disallowed under section 469, the disallowed deductions and credits attributable to each spouse's activities must be separately identified.

The Service invites comment on the treatment of married persons.

VII. Definition of Passive Activity Loss

Section 469(d)(1) defines the term "passive activity loss" as the amount (if any) by which the aggregate losses from all passive activities for the taxable year exceed the aggregate income from all passive activities for such year. In the interest of clarity, § 1.469-2T(b) defines the passive activity loss for the taxable year as the amount, if any, by which the passive activity deductions for the taxable year exceed the passive activity gross income for the taxable year. The rules in § 1.469-2T (c) and (d) identify the items treated as passive activity gross income and passive activity deductions, respectively, for the taxable year.

VIII. Identification of Items of Gross Income and Deductions From Passive Activities

The regulations state that, except as otherwise provided, all items of gross income from a passive activity are included in passive activity gross income, and all deductions arising in connection with a passive activity are passive activity deductions. The regulations do not require that any particular method be employed in determining (a) whether items of income are derived from an activity, (b) whether deductions arise in connection with an activity, or (c) how shared costs should be allocated among activities. The regulations contemplate the use of reasonable methods in making these determinations, and the Service will disregard unreasonable determinations. The Service invites public comment regarding the desirability of detailed rules relating to these issues.

IX. Treatment of Gain From the Disposition of an Interest in an Activity or Property Used in an Activity

A. General Rule: Characterization of Gain at the Time of the Disposition

Gain from a disposition of property used in an activity or of an interest in an activity held through a partnership or S corporation generally is treated as gross income from that activity. Except in the case of gain from a disposition of substantially appreciated property formerly used in a nonpassive activity and gain attributable to such property from a disposition of an interest in a partnership or S corporation, such gain is passive activity gross income if the activity is a passive activity for the taxable year of the disposition.

For purposes of this rule, the gain recognized upon the disposition of a partnership interest or S corporation stock is treated as gain from the disposition of an interest in the activities in which the partnership or S corporation has an interest. Rules relating to the allocation of gain among the activities of a partnership or S corporation and the treatment of gain allocated to an activity that includes substantially appreciated property formerly used in a nonpassive activity are discussed under the heading "Dispostions of interests in partnerships and S corporations".

The Service recognizes that an approach that focuses on the character of the activity at the time of a disposition may in many circumstances appear arbitrary, and considered various other approaches. These approaches, including approaches taking into account the nature of the activity or the use of the property during the taxpayer's entire holding period, were rejected because they are found to be equally arbitrary and substantially more difficult to administer.

The Service invites comment on the rules relating to the treatment of gain from dispositions of interests in activities and interests in property used in activities.

B. Disposition of Property Used in More Than One Activity in the 12 Months Preceding the Disposition

To ensure that the character of gain realized on the disposition of property reflects the use of the property for a reasonable period preceding the disposition, § 1.469-2T(c)(2)(ii) requires the taxpayer to allocate the amount realized on the disposition and the adjusted basis of the property among the activities in which the property was used during the 12-month period preceding the disposition. For purposes of this rule, the term "activity" includes, e.g., personal use and holding for investment.

The regulations provide only that the allocation of amount realized and adjusted basis must be reasonable. Examples illustrate that an allocation among activities is considered reasonable if it is based on the period for which the property is used in each such activity during the 12-month period. These examples are not intended to foreclose the use of other reasonable allocation methods.

In recognition of the recordkeeping burden that this allocation rule may impose, § 1.469-2T(c)(2)(ii) also provides a *de minimis* exception under which the amount realized and adjusted basis of property that was predominantly used in one activity during the 12-month period preceding its disposition may be allocated solely to that activity if the value of the property does not exceed the lesser of (a) $10,000 and (b) 10 percent of the value of all property used in the activity at the time of the disposition.

The Service invites comment on the feasibility of the allocation requirement generally, including comment on allocation rules that may be helpful to taxpayers.

C. Disposition of Substantially Appreciated Property Formerly Used in a Nonpassive Activity

The general rule characterizing gain by reference to the character of the activity in which property is used at the time of disposition could, if not limited, encourage taxpayers to structure dispositions in a manner that generates passive activity gross income in inappropriate situations. Accordingly, § 1.469-2T(c)(2)(iii) provides that any gain from a disposition of substantially appreciated property is treated as not from a passive activity unless the property was used in a passive activity for either (a) 20 percent of the taxpayer's holding period for the property or (b) the entire 24-month period ending on the date of the disposition. For purposes of this rule, property is substantially appreciated if its fair market value is more than 120 percent of its adjusted basis.

D. Pre-1987 Installment Sales

In Notice 87-8, 1987-1 C.B. 421, the Service announced that, under these regulations, gain recognized on the installment method would be treated as not from a passive activity if, but for the use of the installment method, the taxpayer would have taken the gain into account for a taxable year beginning before January 1, 1987. This rule is inconsistent with a proposed technical correction to section 469, and is not included in these regulations. Moreover, the Service will not enforce the rule announced in Notice 87-8 unless and until it is adopted in regulations under section 469.

X. Portfolio Income Excluded From Passive Activity Gross Income

A. General Rule

Section 1.469-2T(c)(3) provides that passive activity gross income does not include portfolio income, which is defined as gross income that is derived from specified sources (including interest, dividends, annuities, and royalties) and is not derived in the ordinary course of a trade or business. Section 1.469-2T(c)(3)(ii) provides that, for purposes of this rule, gross income is treated as derived in the ordinary course of a trade or business only to the extent specifically provided in the regulations. That provision also specifically identifies certain types of income as derived in the ordinary course of a trade or business and provides that the Commissioner may similarly treat additional types of income as similarly derived. The Service invites comment on and ruling requests relating to the treatment of interest, dividends, annuities, and royalties as derived in the ordinary course of a trade or business.

B. Characterization of Royalties From Licensing Intangible Property

Section 1.469-2T(c)(3)(iii)(B) provides that royalties from licensing intangible property may be treated as derived in the ordinary course of a trade or business only if the person receiving such royalties either created the property or performed substantial services or incurred substantial costs with respect to the development or marketing of the property. Although the determinations under this rule are generally based on all of the facts and circumstances, a person will be treated as deriving royalties in the ordinary course of a trade or business if either of two quantitative tests are satisfied. The Service invites public comment on the appropriateness of this rule and the need for additional guidance. In particular, the Service seeks comment on the quantitative tests.

C. Mineral Royalties

The regulations do not include special rules for determining whether mineral royalties are derived in the ordinary course of a trade or business because the Service is continuing to develop criteria for making this determination. The regulations include only one example illustrating the treatment of mineral royalties. This example, which follows from § 1.469-2T(c)(3)(ii)(D), indicates that royalty income derived from royalty interests held in a trade or business activity of trading or dealing in such interests is treated as derived in the ordinary course of a trade or business.

Under § 1.469-2T(c)(3)(ii), the only other mineral royalties treated as income derived in the ordinary course of a trade or business are those identified by the Commissioner. Therefore, unless and until these regulations are amended, taxpayers may not treat mineral royalties (other than royalties derived from a trade or business of trading or dealing in royalty interests) as derived in the ordinary course of a trade or business without obtaining a ruling.

Nonetheless, the Service believes that it may be appropriate to treat a portion of a mineral royalty payment as derived in the ordinary course of a trade or business in some cases not involving a trade or business of trading or dealing in royalty interests. Assume, for example, that royalty income is derived from an overriding royalty interest created on the transfer of a working interest by a partnership engaged in the trade or business of oil and gas development, and that the partnership is not taxed upon receipt of the royalty interest. In such a case, it may be appropriate to treat the royalty payments, by analogy to sections 483 and 1274, as deferred payments with respect to the sale of the working interest. Under this approach, the portion of each royalty payment that represents consideration paid to the partnership for the working interest would be treated as income derived in the ordinary course of a trade or business, and only the interest element in the payments would be treated as portfolio income. The Service invites public comment on whether and how such distinctions should be made, and how depletion deductions should be allocated between portfolio and nonportfolio components of royalty payments.

XI. Personal Service Income Excluded From Passive Activity Gross Income

A. Payments to Partners for the Performance of Services

Section 469(e)(3) provides that earned income (within the meaning of section 911(d)(2)(A)) shall not be taken into account in computing the income or loss from a passive activity for [illegible] taxable year. Section 911(d)(2)(A) defines earned income in a manner that includes all payments to partners for the performance of services. Accordingly, the regulations provide, in § 1.469-2T (c)(4)(i)(A) and (e)(2), that any payments to a partner that are described in section 707 (a) or (c) and represent compensation for the performance of services are excluded from passive activity gross income.

The regulations do not, however, adopt the suggestion of some commentators to treat as personal service income the portion of a partner's distributive share of partnership income that represents the value of the partner's services performed on behalf of the partnership.

B. Income From Retirement Plans

Taxable distributions from pension, profit-sharing, and other retirement plans generally are comprised of compensation for past services and investment income. Both of these components generally are excluded from passive activity gross income. Therefore, § 1.469-2T(c)(4) provides that personal service income includes all income from such distributions

XII. Income From Section 481 Adjustments

If a change in accounting method results in an increase in taxable income under section 481 (a "positive section 481 adjustment"), the portion of the adjustment attributable to activities that were passive activities in the year of change is treated, under § 1.469-2T(c)(5), as passive activity gross income. The portion of the adjustment attributable to an activity is determined by allocating the adjustment among the activities that would have given rise to a positive section 481 adjustment if a separate section 481 adjustment were computed with respect to each activity, in proportion to such hypothetical positive adjustments.

XIII. Income From Oil or Gas Properties With Respect to Which the Taxpayer Benefited From the Working Interest Exception

Section 469(c)(3)(B) provides that, if a taxpayer has a loss for a taxable year from a working interest in an oil or gas property that is treated as not from a passive activity, any net income from such property for any succeeding taxable year shall be treated as not from a passive activity.

A. Pre-1987 Losses and Losses From Material Participation Activities

Section 1.469-2T(c)(6)(i) provides that section 469(c)(3)(B) applies only where a loss from a working interest arises in a taxable year beginning after December 31, 1986, and is treated as not from a passive activity solely by reason of the special working interest exception in section 469(c)(3)(A). Thus, the fact that a loss for a taxable year from an oil or gas well drilled or operated pursuant to a working interest was not subject to limitation under section 469 will not cause income for any succeeding year to be treated as not from a passive activity if either (a) the loss was taken into account for a taxable year beginning prior to January 1, 1987, or (b) the loss was not subject to limitation because the taxpayer materially participated in the activity in which the loss arose.

B. Definition of "Property"

Neither section 469(c)(3)(B) nor the legislative history defines the term "oil or gas property." Section 1.469-2T(c)(6)(iii) provides that, for purposes of applying section 469(c)(3)(B) with respect to a working interest, the term "oil or gas property" means any oil or gas property the value of which is directly enhanced by activities the costs of which are borne by the taxpayer as a result of drilling an oil or gas well with respect to the working interest. Thus, the definition of "property" in section 614(a) and the regulations thereunder is not relevant for this purpose.

The definition of the term "oil or gas property" for purposes of section 469(c)(3)(B) is illustrated by three examples. The first example indicates that if the drilling of a well on one tract reveals that a single reservoir underlies that tract and another tract in which the taxpayer owns an interest, the taxpayer's interests in both tracts are treated as part of the same oil or gas property. The second example indicates that if a well is drilled through two formations, both formations are treated as part of the same oil or gas property. The third example indicates that the mere fact that drilling activities generate information indicating the presence of oil or gas in a general geographical area is insufficient to establish that the value of oil or gas properties in such area is "directly" enhanced by the activities generating the information.

XIV. Passive Activity Deductions

A. General Rule

Section 1.469-2T(d)(1) provides that a deduction is a "passive activity deduction" for a taxable year if the deduction (a) arises in connection with the conduct of an activity that is a passive activity for the taxable year or (b) is carried over from the preceding taxable year under section 469(b). For purposes of this rule, a deduction is treated as arising in the taxable year in which the deduction would be allowable if taxable income for all taxable years were determined without regard to sections 469 and 1211. Thus, for example, if a partner's distributive share of a partnership deduction is disallowed under section 704(d) in 1987, but is not disallowed under section 704(d) (or any other provision other than section 469 or 1211) in 1988, the deduction is treated as arising in 1988.

This rule has two significant effects. First, a deduction is not taken into account in computing the passive activity loss and credit until the first taxable year in which the deduction is not disallowed by any applicable limitation other than those contained in sections 469 and 1211. Second, the determination of whether a deduction from an activity is a passive activity deduction does not depend on the character of the activity in taxable years in which the deduction is disallowed under limitations other than section 469. Thus, in the example in the preceding paragraph, the determination of whether the partner's deduction is a passive activity deduction in 1988 depends solely on whether the activity in which it arises is a passive activity of the partner in 1988.

Section 501(c)(2) of the Tax Reform Act of 1986 provides that section 469 shall not apply to any loss, deduction, or credit carried to a taxable year beginning before January 1, 1987. Consistent with the rule, § 1.469-2T(d)(2)(x) provides that an item of loss or deduction that would have been allowed for a taxable year beginning before January 1, 1987, but for section 465, 704(d), or 1366(d), is not treated as passive activity deduction.

B. Losses From Dispositions

Section 1.469-2T(d)(5) generally treats any loss recognized upon the disposition of property used in an activity or of an interest in an activity held through a partnership or S corporation as a deduction from such activity. Rules relating to the allocation of loss among activities of a partnership or S corporation are discussed under the heading "Dispositions of interests in partnerships and S corporations." Under section 469(g)(1), the loss from a disposition may be treated in whole or in part as a loss that is not from a passive activity. Future regulations will provide rules for determining when a loss is treated under section 469(g)(1) as not from a passive activity.

C. Coordination With Sections 465, 704 (d), and 1366(d)

Since, for purposes of section 469, a deduction is not treated as arising in a taxable year in which it is disallowed under section 465, 704(d), or 1366(d), rules are needed to determine which deductions are disallowed for the taxable year under such sections. Section 1.469-2T(d)(6) provides such rules.

Under § 1.469-2T(d)(6), if section 465, 704(d), or 1366(d) disallows all or any part of the taxpayer's loss attributable to an activity (within the meaning of section 465), or to an interest in a partnership or S corporation, as the case may be, a portion of each deduction taken into account in computing such loss is disallowed. To the extent the regulations under those provisions are not consistent with the rules in § 1.469-2T(d)(6), the Service expects that such regulations will be amended.

The regulations do not include any other rules coordinating section 469 with other limitations on losses and deductions. The Service invites comment on the the need for additional coordination rules.

XV. Special Rules for Partners and S Corporation Shareholders

A. In General

The determination of whether an item of income or deduction from a partnership or S corporation is an item of passive activity gross income or a passive activity deduction, respectively, is made by reference to the taxpayer's participation in the activity that generated the item of income or deduction. Section 1.469-2T(e)(1) provides that, in the case of items of income, gain, loss, and deduction from an activity conducted through a fiscal year partnership or S corporation, the taxpayer's participation is determined for the entity's taxable year. The Service invites comment on the application of this rule.

B. Certain Payments to Partners

Section 1.469-2T(e)(2)(i) provides that items of gross income and deduction attributable to a transaction between a partner and a partnership shall be characterized for purposes of section 469 in a manner consistent with the treatment of such transaction under section 707(a). Section 1.469-2T(e)(2)(ii) provides that a payment to a partner for the performance of services or the use of capital, if described in section 707(c) or section 736(a)(2), is generally characterized for purposes of section 469 and the regulations thereunder as a payment of compensation for services or interest, as the case may be, and not as a distributive share of partnership income. The Service expects that a conforming amendment will be made to § 1.707-1.

In addition, § 1.469-2T(e)(2)(iii) provides that any gain or loss taken into account by a retiring partner or a deceased partner's successor in interest as a result or a deceased partner's successor in interest as a result of a payment under section 736(b) is treated a passive activity gross income or a passive activity deduction only to the extent that the gain or loss would have been treated as passive activity gross income or a passive activity deduction if it had been recognized at the time that the liquidation of the retiring or deceased partner's interest commenced.

C. Dispositions of Interests in Partnerships and S Corporations

In general, for Federal income tax purposes, a disposition of an interest in a partnership or S corporation (a "passthrough entity") is treated as a disposition of such interest, rather than as a disposition of an interest in each of the entity's assets. The Service believes that the accurate measurement of passive activity gross income and deductions would be furthered by requiring such a disposition to be treated as a disposition of an interest in the passthrough entity's assets. The regulations nonetheless have not adopted this approach as the general rule because a reasonably accurate measurement of passive activity gross income and deductions generally may be accomplished by allocating the gain or loss from the disposition of an interest in a passthrough entity among the entity's activities.

Section 1.469-2T(e)(3) contains rules governing the treatment, for purposes of the passive loss and credit limitations, of a disposition of an interest in a passthrough entity by a holder of such an interest (the "holder"). A transitional rule also is provided.

The general rule, contained in § 1.469-2T(e)(3)(ii), requires a holder's gain or loss from a disposition of an interest in a passthrough entity (including gain or loss recognized under section 731(a)) to be allocated among the activities of the passthrough entity in proportion to the amounts of gain or loss, respectively, that would have been allocated to the holder by the passthrough entity with respect to each of the entity's activities if the entity had sold its interests in such activities on the applicable valuation date. Generally, the passthrough entity may select either the beginning of the taxable year of the passthrough entity in which the holder's disposition occurs or the date of such disposition as the applicable valuation date. The date of the holder's disposition of an interest in the passthrough entity must be used as the applicable valuation date, however, if since the beginning of the entity's taxable year the entity has sold a significant amount of the property used in any activity or the holder has contributed a significant amount of substantially appreciated or substantially depreciated property to the passthrough entity. For purposes of this rule, property is substantially appreciated if its fair market value exceeds 120 percent of its adjusted basis, and property is substantially depreciated if its adjusted basis exceeds 120 percent of its fair market value.

Under § 1.469-2T(e)(3)(iii), gain from a holder's disposition of an interest in a passthrough entity that is allocated to a passive activity under the general rule will nonetheless be treated as gain that is not from a passive activity if (a) gain that would be treated as gain that is not from a passive activity under § 1.469-2T(c)(2)(iii) would have been allocated to the holder if all of the property used in the activity had been sold, and (b) the amount of that gain exceeds 10 percent of the holder's gain from the disposition that is allocated to the activity under the general rule. This rule is designed to prevent taxpayers from using passthrough entities to structure dispositions of property in a manner that generates passive income in situations where such income would otherwise be treated as not from a passive activity under § 1.469-2I(c)(2)(iii).

Section 1.469-2T(c)(3)(iv) provides a transitional rule for dispositions of interests in a passthrough entity that occur during any taxable year of the entity beginning prior to February 19, 1988. Under this transitional rule, gain or loss from a qualifying disposition of an interest in the entity may be allocated among the activities of the entity under any reasonable method that the selects. This transitional rule does not apply to any sale of an interest in a passthrough entity that occurs after February 19, 1988, if the holder contributes certain substantially appreciated property (as defined above) to the entity after that date.

The Service continues to study the issues presented by dispositions of interests in passthrough entities and invites comment on the treatment accorded these dispositions under § 1.469-2T(e)(3).

XVI. Recharacterization of Certain Passive Activity Gross Income

A. In General

Section 469 was intended to prevent taxpayers from using losses from rental activities and passive business activities to shelter any of three types of income: (a) Personal service income, (b) active business income, and (c) Portfolio investment income. Congress recognized the difficulty of writing statutory rules that would clearly distinguish income in these classes from income properly falling in the rental or passive business income category, and anticipated the need for additional rules to address transactions structured in order to maximize the amount of income treated as rental or passive business income. Consequently, Congress enacted section 469 (1), (2), and (3), granting to the Secretary the authority to prescribe regulations that eliminate certain items of gross income, or the net income from certain activities, from the computation of the passive activity loss and credit.

The Conference Report accompanying the Act states that the Secretary's regulatory authority is intended to be "exercised to protect the underlying purpose of the passive loss provision, i.e., preventing the sheltering of positive income sources through the use of tax losses derived from passive business activities." H.R. Conf. Rep. No. 99-841, 99th Cong., 2nd Sess., vol. II, at 147 (1986).

In the absence of regulations, taxpayers would be encouraged to generate passive activity gross income by (a) changing their participation in, and the ownership structure of, their active businesses, and (b) replacing their portfolio investments with investments in rental or passive business activities that share many of the investment characteristics of traditional portfolio investments. Although attempts to derive capital income from rental or passive business sources are not generally abusive, they could, if undeterred, frustrate Congress' intent that the passive loss provision prevent "the sheltering of positive income sources." Thus, § 1.469-2T(f) requires that income from certain activities be treated as income that is not from a passive activity.

Since taxpayers could not clearly foresee the particular recharacterization rules that these regulations would adopt, the provisions in § 1.469-2T(f) that recharacterize income from activities based on factors other than the taxpayer's participation in such activities do not apply to gross income taken into account for any taxable year beginning before January 1, 1983. In addition, the rule recharacterizing income from self-rented property does not apply to income that is attributable to the rental of property pursuant to a written binding contract entered into before February 19, 1988.

The rules contained in § 1.469-2T(f) apply only to gross income that, in the absence of such rules, would be treated as passive activity gross income. Thus, if an activity is not a passive activity, the rules in § 1.469-2T(f) do not apply to gross income from the activity. Moreover, except as specifically provided by regulation, the fact that an amount of gross income from an activity is recharacterized under § 1.469-2T(f) does not cause that activity to be treated as other than a passive activity for purposes of section 469 or these regulations.

B. Rules Preventing Conversion of Active Business Income Into Passive Activity Gross Income

1. Passive activities in which the taxpayer's participation is significant. The Service recognizes that, in the case of an activity that is not the full-time occupation of the taxpayer, the rules regarding material participation set forth in § 1.469-5T are stringent. As a result, a taxpayer spending relatively small amounts of time in unrelated activities could, in the absence of regulations, treat the gross income from such activities as passive activity gross income even though the taxpayer's participation and services are significant factors in generating the income from the activities.

In view of this concern, § 1.469-2T(f)(2) provides that an amount of the taxpayer's gross income from a significant participation passive activity equal to the taxpayer's net passive income from the activity is treated as not from a passive activity. For purposes of this rule, a significant participation passive activity is an activity (other than a rental activity) in which the taxpayer participates for more than 100 hours, but does not materially participate, for the taxable year.

The Service does not believe it appropriate to treat the taxpayer's net income, but not the taxpayer's net losses, from activities as nonpassive if the taxpayer's involvement in such activities is substantial. Accordingly, § 1.469-5T(a)(4) provides that a taxpayer materially participates in activities that would otherwise be significant participation passive activities for purposes of § 1.469-2T(f)(2) if the taxpayer's participation in all such activities exceeds 500 hours for the taxable year.

2. Activities involving the rental of property developed by the taxpayer. In general, an activity involving the rental of property is a passive activity. Under § 1.469-2T(c)(2), gain from the disposition of property used in a passive activity generally is treated as passive activity gross income. It is not appropriate, however, to treat a taxpayer's gain from the sale of a rental property as passive activity gross income if the taxpayer materially or significantly participated in the development of the property and the gain is predominantly attributable to the development of the property rather than to appreciation during the rental period.

Accordingly, § 1.469-2T(f)(5) provides that, in certain situations, an amount of a taxpayer's gross income from renting and selling an item of property equal to the taxpayer's net passive income from such rental and sale is treated as not from a passive activity. This rule applies if (a) any gain from the sale, exchange, or other disposition of the property is included in the taxpayer's income for the taxable year, (b) during any taxable year the taxpayer materially or significantly participated in a trade or business activity involving the performance of services for the purpose of enhancing the value of the property, and (c) a binding contract for the sale or exchange was entered into less than 24 months after the rental of the property commenced.

In general, the effect of this rule is that property developed by the taxpayer must be rented for at least 24 months prior to selling the property or contracting for its sale or the taxpayer's gain from the sale will not be treated as passive activity gross income.

3. Self-rented property. As indicated above, section 469 is intended, in part, to prevent taxpayers from sheltering active business income with losses from rental activities and passive business activities. Income from an active business consists of both income from services and income from capital invested in the business. In the absence of regulations, a taxpayer could derive passive activity gross income from an active business in which tangible property is used by renting the property to an entity conducting the activity (or by causing an entity holding the property to rent the property to the taxpayer). It would be inconsistent with the purposes of section 469 to treat rental income as passive activity gross income in such cases, and the Conference Report accompanying the Act states that it would be appropriate for the Service to exercise its regulatory authority under section 469(1)(3) in the case of "related party leases or sub-leases, with respect to property used in a business activity, that have the effect of reducing active business income and creating passive income." H.R. Conf. Rep. No. 99-841, 99th Cong., 2nd Sess., vol. II, at 147 (1986).

Accordingly, § 1.469-2T(f)(6) provides that an amount of the taxpayer's gross income from renting an item of property equal to the taxpayer's net passive income from such rental is treated as not from a passive activity if the property is rented for use in a trade or business activity in which the taxpayer materially participates for the taxable year. The Service recognizes that it has the authority to treat part or all of the taxpayer's rental expense in such cases as a self-charged item, and that the amount of rental income that is recharacterized under § 1.469-2T(f)(6) may exceed the amount of income that it would be appropriate to recharacterize as a self-charged item. The Service invites comments on the relationship between this rule and the rules to be provided under § 1.469-7T (relating to the treatment of self-charged items of income and expense).

C. Rules Preventing Conversion of Portfolio Income Into Passive Activity Gross Income

1. Activities involving the rental of nondepreciable property. The Conference Report accompanying the Act states that it may be appropriate for the Service to treat "ground rents that produce income without significant expenses" as not from a passive activity. Consistently with this suggestion, § 1.469-2T(f)(3) provides that an amount of the taxpayer's gross income from an activity of renting nondepreciable property equal to the taxpayer's net passive income from the activity is treated as not from a passive activity. Since nondepreciable property may be rented together with incidental depreciable property (e.g., land with minor improvements), raising a factual issue as to whether an activity in which nondepreciable property is leased consists primarily of renting such property, § 1.469-2T(f)(3) provides a bright line for distinguishing activities involving the rental of nondepreciable property from other rental activities. Under the regulations, income from a rental activity is subject to this recharacterization rule if the unadjusted basis of the depreciable property rented in the activity is less than 30 percent of the unadjusted basis of all property rented in the activity. The Service invites comment regarding the appropriateness of this objective standard.

2. Equity-financed lending activities. Under § 1.469-2T(c)(3)(ii)(A), interest income from loans made in the ordinary course of a trade or business of lending money is not portfolio income. Absent a regulation expressly treating income from such an activity as nonpassive income, taxpayers could derive passive income from investments substantially similar to mutual fund investments by becoming passive investors in partnerships or S corporations that engage in a trade or business of lending equity funds contributed by the taxpayers. Permitting such income to be treated as passive income would be inconsistent with the purpose of section 469 to prevent the sheltering of portfolio income with losses from rental and passive business activities. On the other hand, income derived from borrowing money and lending the proceeds at a higher interest rate does not resemble the kind of portfolio income which Congress intended to protect from sheltering by passive losses.

Accordingly, § 1.469-2T(f)(4) treats as nonpassive income an amount of the taxpayer's gross income from an equity-financed lending activity equal to the lesser of (a) the taxpayer's equity-financed interest income from the activity or (b) the taxpayer's net passive income from the activity. This rule applies to the lending activities in which the average balance of debt incurred in the activity (determined at the entity level) does not exceed 80 percent of the average balance of interest-bearing assets held in the activity. In general, the taxpayer's equity-financed interest income from the activity is equal to the taxpayer's interest income from the activity multiplied by the activity's ratio of equity to interest-bearing assets. This rule is designed to treat as nonpassive income only that portion of the taxpayer's income from the activity that approximates the product of (a) the average interest rate of the activity's interest-bearing assets and (b) the taxpayer's equity contribution to the activity.

3. Passthrough entities licensing intangible property. Section § 1.469-2T(c)(3)(iii)(B) provides that royalty income received by a passthrough entity from the licensing of intangible property may be treated as income derived in the ordinary course of a trade or business if the entity (a) created the property or (b) performed substantial services or incurred substantial costs with respect to the development or marketing of the property. This treatment is appropriate in the case of a taxpayer who owns an interest in such an entity at the time that the entity creates such property, performs such services, or incurs such costs. If, however, a taxpayer acquires an interest in such an entity after the entity creates such property, performs such services, or incurs such costs, the taxpayer's royalty income resembles portfolio income rather than income derived in the ordinary course of a trade or business. Accordingly, § 1.469-2T(f)(7) provides that an amount of the taxpayer's gross income from such property equal to the taxpayer's net passive income from such property is generally treated as not from a passive activity. The Service invites comment on the rules employed in § 1.469-2T(f)(7) to determine when taxpayers are subject to this rule.

D. Limitation on Recharacterized Income

The rules contained in § 1.469-2T(f)(2) (relating to significant participation activities), § 1.469-2T(f)(3) (relating to the rental of nondepreciable property), and § 1.469-2T(f)(4) (relating to equity-financed lending activities) treat as nonpassive income an amount of the taxpayer's gross income from an activity equal to the taxpayer's net passive income from the activity. Under § 1.469-2T(f)(9)(i), the taxpayer's "net passive income" from an activity for a taxable year is the excess of the taxpayer's passive activity gross income from the activity for the year (determined without regard to these recharacterization rules) over the taxpayer's passive activity deductions from the activity for the year. The rules contained in § 1.469-2T(f)(5) (relating to the rental of property developed by the taxpayer), § 1.469-2T(f)(6) (relating to self-rented property), and § 1.469-2T(f)(7) (relating to passthrough entities licensing intangible property) are similar, but apply on a property-by-property basis.

Taxpayers should note that, under § 1.469-2T(d)(1)(ii), a deduction from an activity that is disallowed under section 469 for a taxable year is treated as a passive activity deduction from the activity for the succeeding taxable year and that, under § 1.469-2T(f)(7)(ii)(B) and (9)(iv), a similar rule applies when deductions reasonably allocable to an item of property are disallowed. Thus, if a taxpayer's loss from an activity or an item of property is disallowed for a taxable year, the taxpayer's net passive income from the activity or property for the succeeding year is reduced by the amount of such disallowed loss. As a result, the regulations do not treat income from an activity or an item of property as nonpassive income while, at the same time, prohibiting the deduction of previously disallowed losses from such activity or property.

Although prior-year losses from an activity or an item of property subject to the rules contained in § 1.469-2T(f) generally carry forward and reduce the amount of gross income that is treated as nonpassive income under those rules, this is not the case to the extent any such loss for the prior taxable year exceeds the disallowed loss allocated to such activity or property for such year under the rules of § 1.469-1T(f). In that event, the excess loss has in effect absorbed passive income, thereby resulting in the disallowance of passive losses from other activities. The Service is studying the interaction between the rules for allocating disallowed losses and rules, such as those contained in § 1.469-2T(f) and those to be provided with respect to former passive activities, under which a carryover loss may be allowed to the extent of income that would otherwise be treated as nonpassive income. The Service invites suggestions for the coordination of those rules.

E. Possible Recharacterization Rules to be Contained in Future Regulations

The Service recognizes that the rules in these regulations are not exhaustive and that taxpayers may structure additional investments that have economic characteristics similar to those of portfolio investments so as to derive passive activity gross income from such investments. The Service intends to monitor developments in this area closely, and anticipates prescribing additional regulations to the extent necessary to prevent portfolio-type income from being treated as passive activity gross income. In general, any such additional regulations would apply prospectively only. In appropriate circumstances, however, the regulations might apply to income, derived after the date the regulations are published, from investments made prior to such date, but in such cases the rules would be issued in proposed form (rather than as temporary regulations), with a period for public comment before the regulations become final.

During the preparation of these regulations, the Service considered an approach to recharacterizing certain passive activity gross income that is illustrative of the kinds of additional regulations the Service may prescribe in the future. Under this approach, gross income attributable to a preferred or guaranteed return from an investment (i.e., a return that through preferences or other arrangements is derived from sources other than the taxpayer's own invested capital) would be treated as portfolio income.

Some commentators have suggested that such a rule should address the following situation:

> A limited partnership is formed to acquire a rental property for $10 million. The general partner contributes $5 million to the partnership and the remaining $5 million of partnership capital is raised through a private placement of limited partnership interests to five individuals. The partnership agreement allocates 99 percent of partnership taxable income to the limited partners until the income allocated to them equals a 10 percent cumulative annual return on their invested capital, with any remaining taxable income allocated 15 percent to the limited partners and 85 percent to the general partner. Thus, the income earned on the general partner's invested capital will be applied, if necessary, to satisfy the limited partners' right to a 10 percent cumulative return.

Because of the limited partners' preferential right to income, their interests, depending on circumstances such as the nature of the partnership's investment, may have the characteristics of a portfolio investment. The Service considered an approach under which a limited partner's gross income attributable to a preferred return would in certain circumstances be treated as portfolio income. The Service continues to study this approach and invites comment on the circumstances in which a "preferred" or "guaranteed" return should be treated as portfolio income.

XVII. Passive Activity Credit

A. Credits Subject to Section 469

A credit may be limited under section 469 if it is from a passive activity and is described in section 38 (b) (1) through (5) (relating to general business credits), section 27(b) (relating to section 936 corporations), section 28 (relating to clinical testing of certain drugs), or section 29 (relating to fuel from nonconventional sources).

Section 1.469-3T(b) provides that a credit is treated as from a passive activity if (a) it arises in connection with a passive activity (i.e., an activity that is passive for the taxable year in which the credit would be allowed if section 469 and other specified limitations did not apply) or (b) in the case of a credit attributable to qualified progress expenditures (within the meaning of section 46(d)), it is reasonable to believe that the progress expenditure property (within the meaning of section 46(d)(2)) will be used in a passive activity when it is placed in service. Thus, for example, a credit attributable to qualified rehabilitation expenditures (within the meaning of section 48(g)(2)) which is allowed for the taxable year under section 46(d), is treated as a credit from a passive activity of the taxpayer if either (a) the activity in which the qualified rehabilitation expenditures are paid or incurred is a passive activity of the taxpayer for the taxable year in which such expenditures are paid or incurred, or (b) it is reasonable to believe that the rehabilitated property will be used in a passive activity of the taxpayer when it is placed in service.

B. Determination of Regular Tax Liability Allocable to Passive Activities

Under section 469(d)(2), the passive activity credit is the amount by which the sum of the taxpayer's credits that are subject to section 469 for the taxable year exceeds the taxpayer's regular tax liability allocable to all passive activities for such year. Section 469(j)(3) provides that the term "regular tax liability" has the meaning given such term by section 26(b). Section 1.469-3T(d)(1) provides that the taxpayer's regular tax liability for the taxable year that is allocable to all passive activities is the regular tax liability on the excess of the taxpayer's taxable income for the year over the amount by which the taxpayer's passive activity gross income exceeds the taxpayer's passive activity deductions for the taxable year.

C. Coordination With Other Limitations on Credits

In general, the limitation on the passive activity credit applies before all other limitations that may apply to credits from passive activities (other than the limitation in section 41(g) (relating to research credits of certain individuals)). If a credit is subject to section 469 for a taxable year but is not disallowed by section 469, the credit becomes subject to other limitations in the same manner as credits from activities that are not passive activities. In determining the years to which a general business credit may be carried, the credit is treated for purposes of section 39 as a current year business credit in the first taxable year in which the credit is subject to section 469 but is not disallowed thereby.

XVIII. Material Participation

A. In General

Under § 1.469-5T(a), an individual is treated as materially participating in an activity for a taxable year if and only if the individual meets one of seven tests. The first four tests (contained in § 1.469-5T(a) (1) through (4)) are quantitative in nature, and are based on the number of hours spent participating in the activity during the year. The fifth and sixth tests (contained in § 1.469-5T(a) (5)) and (6)) are based on material participation by the taxpayer in prior years. The seventh test (contained in § 1.469-5T (a)(7)) is a facts-and-circumstances test.

B. Quantitative tests

Under § 1.469-5T(a)(1), an individual is treated as materially participating in an activity for a taxable year if the individual participates in the activity for more than 500 hours during the year.

The Service believes that the 500-hour test will have the effect of restricting deductions from the types of trade or business activities that Congress intended to treat as passive activities, since few investors in traditional tax shelters devote more than 500 hours during a taxable year to any such investment. In addition, the Service believes that income from an activity in which an individual participates for more than 500 hours during a taxable year is not properly classified as income from a passive activity.

Under § 1.469-5T(a)(2), an individual is treated as materially participating in an activity for a taxable year if the individual's participation in the activity for the year constitutes substantially all of the participation in the activity for the taxable year. Section 1.469-5T(a)(3) treats an individual as materially participating in an activity for a taxable year if the individual participates in the activity for more than 100 hours during the taxable year, and the individual's participation in the activity for the year is not less than that of any other individual. These rules are included because the service recognizes that the operation of some activities may not require more than 500 hours of participation, or may not require more than 500 hours of participation by any one individual during a taxable year.

Under § 1.469-5T(a)(4), an individual is treated as materially participating in all of the individual's significant participation activities for a taxable year if the individual's aggregate participation is significant participation activities for the year exceeds 500 hours. For purposes of this rule, a significant participation activity is a trade or business activity in which the individual participates for more than 100 hours during the taxable year but in which the individual does not materially participate for the year (without regard to this rule). This rule is included because the Service believes that an individual who devotes more than 500 hours during a taxable year to several activities, each of which is significant activity of such individual, should be treated similarly to an individual who devotes an equivalent amount of time to a single activity.

C. Tests Based on Material Participation in Prior Years

Under § 1.469-5T(a)(5), an individual is treated as materially participating in an activity for a taxable year if the individual materially participated in such activity for any five of the ten taxable years that immediately precede the taxable year.

Under § 1.469-5T(a)(6), an individual is treated as materially participating in a personal service activity for a taxable year if the taxpayer materially participated in the activity for any three taxable years that precede the taxable year. For purposes of this rule, an activity is a personal service activity if it principally involves the performance of personal services in (a) the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or (b) any other trade or business in which capital is not a material income-producing factor.

These rules are included because the Service believes that an activity in which an individual has materially participated over a long period of time or a personal service activity in which an individual has participated for a substantial period of time is likely to represent the individual's principal livelihood rather than a passive investment. In particular, the Service does not believe that withdrawal from a longstanding active business or from a personal service business that has been active for a substantial period should convert an individual's earnings from the business to passive income. Thus, the Service believes the income from such businesses generally is part of the earned income base that section 469 was intended to protect. In the case of a longstanding active business (other than a personal service business), however, the Service believes that a continuing interest in such an activity is more appropriately viewed as an investment in a passive activity if the individual has not materially participated in the activity for a significant period of time during the 10-year period immediately preceding the taxable year.

D. Facts-and-Circumstances Test

Section 1.469-5T(a)(7) provides that an individual may be treated as materially participating in an activity for a taxable year based on all of the facts and circumstances. The general principles to be followed in applying the facts-and-circumstances test are not addressed in these regulations, and will be included in future regulations. Section 1.469-5T(b), however, provides that certain participation is insufficient to constitute material participation, or is not taken into account, under this test. Thus, except as provided in section 469(h)(3), the fact that an individual satisfies participation standards in other provisions of the Code and the regulations (such as the "material participation" standards in sections 1402 and 2032A) is not taken into account in determining whether the individual materially participates in an activity for purposes of section 469. In addition, an individual's participation in management of an activity is not taken into account in applying the facts-and-circumstances test to the individual if a paid manager participates in the activity or if the management services performed by such individual are exceeded by those performed by any other individual. Finally, an individual who does not participate in an activity for more than 100 hours during the taxable year cannot satisfy the facts-and-circumstances test for the year.

E. Treatment of Limited Partners

Section 469(h)(2) provides that, except as provided in regulations, no interest in a limited partnership shall be treated as an interest with respect to which a taxpayer materially participates. Section 1.469-5T(d) provides two exceptions to this general rule. First, the general rule does not apply to an activity for a taxable year if (a) the taxpayer participates in the activity for more than 500 hours during the taxable year, or (b) the taxpayer is treated as materially participating in the activity for the taxable year under either the longstanding material participant test or the personal-service-activity test. Second, the general rule does not apply with respect to a limited partnership interest in a partnership in which the taxpayer is also a general partner.

F. Trusts and Estates

Material participation rules for trusts and estates will be included in future regulations providing rules for the application of section 469 to trusts, estates, and their beneficiaries.

G. Meaning of "Participation"

Section 1.469-5T(f) generally provides that all work done in an activity by an individual who owns an interest in the activity (other than an interest owned through a C corporation) is taken into account as participation by the individual in the activity, without regard to the capacity in which the individual does such work. Thus, work performed by an individual as an employee of a C corporation in connection with an activity in which the individual owns an interest (other than an interest owned through a C corporation) is taken into account as participation by the individual in the activity.

Section 1.469-5T(f) includes two exceptions to this general rule. First, under § 1.469-5T(f)(2)(i), work that is not customarily done by an owner is not taken into account if a principal purpose for the performance of such work is to avoid the disallowance of a passive activity loss or credit. Second, under § 1.469-5T(f)(2)(ii), work done by an individual in connection with an activity in the individual's capacity as an investor in the activity is not taken into account.

In the case of a married individual, § 1.469-5T(f)(3) provides that the participation of the individual's spouse is treated as participation by such individual for purposes of the passive loss and credit limitations, without regard to whether the participation of the spouse is material participation in its own right, whether the spouse owns an interest in the activity, or whether the individual and the individual's spouse file a joint return for the taxable year.

H. No Recordkeeping Requirements

Notwithstanding the quantitative tests set forth in the regulations, § 1.469-5T(f)(4) expressly provides that taxpayers need not keep contemporaneous records of their hours of participation in each activity. The Service recognizes that, while lawyers and certain other professionals are accustomed to maintaining detailed records of how they spend their work days, most individuals do not customarily maintain such records. Accordingly, under the regulations, taxpayers will be allowed to prove the requisite number of hours by any reasonable means, including, but not limited to, appointment books, calenders, and narrative summaries.

I. Material Participation for Taxable Years Beginning Before January 1, 1987

A taxpayer's participation in an activity for a taxable year beginning before January 1, 1987, may be relevant under rules such as those relating to longstanding material participants and personal service activities. Section 1.469-5T(j) provides that in any case in which it is necessary to determine whether an individual materially participated in an activity for any taxable year beginning before January 1, 1987 (other than a taxable year of a partnership, S corporation, estate, or trust ending after December 31, 1986), the individual is treated as materially participating in the activity for such year only if the individual participated in the activity for more than 500 hours during the year. The Service believes that the 500-hour test represents the only administrable rule for dealing with the determination of material participation for taxable years beginning before 1987.

XIX. Effective date and transition rules.

A. In General

Section 469 and the regulations thereunder generally apply for taxable years beginning after December 31, 1986. However, under § 1.469-11T(a)(2), specified rules in § 1.469-2T(f) treating certain income as not from a passive activity apply only for taxable years beginning after December 31, 1987. These provisions are § 1.469-2T(f)(3) (relating to the rental of nondepreciable property), § 1.469-2T(f)(4) (relating to equity-financed lending activities), § 1.469-2T(f)(5) (relating to the rental of property developed by the taxpayer), § 1.469-2T(f)(6) (relating to self-rented property), and § 1.469-2T(f)(7) (relating to passthrough entities licensing intangible property). In addition, § 1.469-2T(f)(6) does not apply to income attributable to the rental of property pursuant to a written binding contract entered into before February 19, 1988.

If a taxpayer is a partner, shareholder, or beneficiary of a partnership, S corporation, estate, or trust with a taxable year ending within the taxpayer's first taxable year beginning after December 31, 1986, passive items from such partnership, S corporation, estate, or trust are taken into account in computing the taxpayer's passive activity loss or credit even if such items are attributable to taxable years of such entities beginning before January 1, 1987, or are attributable to amounts paid or incurred prior to January 1, 1987. Under § 1.469-2T(e)(1), the treatment of an item of gross income, deduction, or credit from a fiscal year partnership or S corporation as passive activity gross income, as a passive activity deduction, or as a credit from a passive activity, respectively, is determined by reference to the taxpayer's participation in the activity to which such item relates for the partnership's or S corporation's taxable year in which the item arose. Future regulations relating to the treatment of beneficiaries of estates and trusts will provide guidance on this issue with respect to such taxpayers.

B. Effect of Events Occurring in Years Beginning Prior to 1987

Because in certain instances the treatment under the regulations of an item of gross income, deduction, or credit for the taxable year is determined in part by reference to events in prior taxable years, § 1.469-11T(a)(4) provides that events in prior taxable years generally are taken into account in making such determinations. For example, under § 1.469-5T(a)(5), an individual is treated as materially participating in an activity for the taxable year if the individual materially participated in the activity for any five of the ten taxable years that immediately precede the taxable year. Under § 1.469-11T(a)(4), a taxable year beginning prior to January 1, 1987, is taken into account for this purpose, but only if the individual participated in the activity for more than 500 hours during such taxable year.

C. Transitional Rule for Losses From Pre-Enactment Interest

1. In general. Section 469(m) provides a transitional rule for losses and credits attributable to pre-enactment interests in passive activities. Under that rule, which applies for taxable years beginning prior to 1991, the amount of the taxpayer's passive activity loss or passive activity credit that would be disallowed in the absence of the transitional rule is reduced by an amount equal to the product of a percentage and the lesser of (a) the amount of the passive activity loss or passive activity credit that would be disallowed in the absence of the transitional rule, or (b) the amount of the passive activity loss or passive activity credit that would be disallowed in the absence of the transitional rule (determined without taking into account previously disallowed passive items or passive items that are not attributable to the taxpayer's pre-enactment interests in passive activities). The percentage is 65 percent for taxable years beginning in 1987, 40 percent for taxable years beginning in 1988, 20 percent for taxable years beginning in 1989, and 10 percent for taxable years beginning in 1990.

Paragraphs (b) and (c) of § 1.469-11T (b) contain rules relating to the identification of pre-enactment interests in passive activities and the computation of the amount of the passive activity loss and credit that would be disallowed if passive items that are not attributable to the taxpayer's pre-enactment interests in passive activities were not taken into account.

2. *Indentification of pre-enactment interests.* Under section 469(m), a taxpayer's pre-enactment interests must be identified for each taxable year during the transition period. Thus, for each such taxable year, the taxpayer must determine which of the taxpayer's interests in activities that are passive activities for the taxable year are pre-enactment interests. Under § 1.469-11T (c)(1), a pre-enactment interest is a "qualified interest" in a "pre-enactment activity."

Section 1.469-11T(c)(3) provides that an activity is a "pre-enactment activity" if the activity was being conducted by any person on October 22, 1986, or if at least 50 percent (by value) of the property used in the activity during the taxable year was in existence or under construction on August 16, 1986, or was acquired or constructed at any time pursuant to a written binding contract in effect on August 16, 1986 (without regard to whether the taxpayer or any person related to the taxpayer was a party to such contract). Thus, for example, in the case of an activity of renting a building, the activity is a pre-enactment activity if the building was in existence or under construction on August 16, 1986.

Section 1.469-11T(c)(2) provides that an interest in an activity is a "qualified interest" if the interest was held by the taxpayer on October 22, 1986, and at all times thereafter, or was acquired by the taxpayer pursuant to written binding contracts to which the taxpayer was a party on October 22, 1986. Section 1.469-11T(c)(7) provides rules for determining whether a taxpayer was a party to a written binding contract on October 22, 1986. Under those rules, for example, if on October 22, 1986, a taxpayer was a party to a written binding contract to acquire a partnership interest, and the partnership was a party to a written bining contract to acquire an interest in an activity, the taxpayer is treated as a party to the partnership's contract.

3. *Computation of pre-enactment loss and credit.* Section 1.469-11T(b)(3) and (4) contains rules relating to the computation of the amount of the passive activity loss and credit that would be disallowed if the passive items that are not attributable to the taxpayer's pre-enactment interests in passive activities were not taken into account. The amounts determined under § 1.469-11T(b)(3) (relating to the pre-enactment loss) and § 1.469-11T(b)(4) (relating to the pre-enactment credit) are the amounts of the passive activity loss and the passive activity credit, respectively, that would be disallowed under § 1.469-1T(a)(1) taking into account all of the provisions of section 469 and the regulations thereunder, but applying such provisions as though the taxpayer had no interests in passive activities other than the taxpayer's pre-enactment interests. Under these rules, deductions and credits disallowed in a prior year and taken into account for the taxable year under section 469(b) (including deductions and credits attributable to pre-enactment interests) also are not taken into account.

Special Analyses

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

LIST OF SUBJECTS IN 26 CFR 1.441-1—1.483-2

Income taxes, Accounting, Deferred compensation plans.

Adoption of Amendments to the Regulations

For the reasons set forth in the preamble, Title 26, Chapter I, Subchapter A, Part 1 of the Code of Federal Regulations is amended as set forth below:

PART 1—[AMENDED]

Income Tax Regulations

PARAGRAPH 1. The authority for Part 1 is amended by adding the following citation:

AUTHORITY: 26 U.S.C. 7805. * * * Sections 1.469-1T, 1.469-2T, 1.469-3T, 1.469-5T, and 1.469-11T also issued under 26 U.S.C. 469(l).

PAR. 2. The following new sections are added to Part 1 in the appropriate place:

§ 1.469-0T Table of contents (temporary).

This section lists the captions that appear in the temporary regulations under section 469.

§ 1.469-1T GENERAL RULES (TEMPORARY).

(a) Passive activity loss and credit disallowed.
  (1) In general.
  (2) Exceptions.
(b) Taxpayers to whom these rules apply.
(c) Cross references.
  (1) Definition of passive activity.
  (2) Passive activity loss.
  (3) Passive activity credit.
  (4) Effect of rules for other purposes.
  (5) Special rule for oil and gas working interests.
  (6) Treatment of disallowed losses and credits.
  (7) Corporations subject to section 469.
  (8) Consolidated groups.
  (9) Joint returns.
  (10) Material participation.
  (11) Effective date and transition rules.
  (12) Future regulations.
(d) Effect of section 469 and the regulations thereunder for other purposes.
  (1) Treatment of items of passive activity income and gain.
  (2) Coordination with section 1211.
  (3) Treatment of passive activity losses.
(e) Definition of "passive activity."
  (1) In general.
  (2) Trade or business activity.

(i) In general.
(ii) Certain activities not involving the conduct of a trade or business treated as trade or business activities. [Reserved]
(3) Rental activity.
(i) In general.
(ii) Exceptions.
(iii) Average period of customer use.
(iv) Significant personal services.
(A) In general.
(B) Excluded services.
(v) Extraordinary personal services.
(vi) Rental of property incidental to a nonrental activity of the taxpayer.
(A) In general.
(B) Property held for investment.
(C) Property used in a trade or business.
(D) Property held for sale to customers.
(E) Lodging rented for convenience of employer.
(F) Unadjusted basis.
(vii) Property made available for use in a nonrental activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.
(viii) Examples.
(4) Special rule for oil and gas working interests.
(i) In general.
(ii) Exception for deductions attributable to a period during which liability is limited.
(A) In general.
(B) Coordination with rules governing the identification of disallowed passive activity deductions.
(C) Meaning of certain terms.
(*1*) Allocable deductions.
(*2*) Disqualified deductions.
(*3*) Net loss.
(*4*) Ratable portion.
(iii) Examples.
(iv) Definitions of "working interest."
(v) Entities that limit liability.
(A) General rule.
(B) Other limitations disregarded.
(C) Examples.
(vi) Cross reference to special rule for income from certain oil or gas properties.
(5) Rental of dwelling unit.
(6) Activity of trading personal property.
(i) In general.
(ii) Personal property.
(iii) Example.
(f) Treatment of disallowed passive activity losses and credits.
(1) Scope of this paragraph.
(2) Identification of disallowed passive activity deductions.
(i) Allocation of disallowed passive activity loss among activites.
(A) General rule.
(B) Loss from an activity.
(C) Significant participation passive activities.
(D) Examples.
(ii) Allocation within loss activities.
(A) In general.
(B) Excluded deductions.
(iii) Separately identified deductions.
(3) Identification of disallowed credits from passive activites.
(i) General rule.
(ii) Coordination rule.
(iii) Separately identified credits.
(4) Carryover of disallowed deductions and credits.
(g) Application of these rules to C corporations.
(1) In general.
(2) Definitions.
(3) Participation of corporations.
(i) Material participation.
(ii) Significant participation.
(iii) Participation of individual.
(4) Modified computation of passive activity loss in the case of closely held corporations.
(i) In general.
(ii) Net active income.
(iii) Examples.
(5) Allowance of passive activity credit of closely held corporations to extent of net active income tax liability.
(i) In general.
(ii) Net active income tax liability.
(h) Special rules for affiliated group filing consolidated return.
(1) In general.
(2) Definitions.
(3) Disallowance of consolidated group's passive activity loss or credit.
(4) Status and material participation of members.
(i) Determination by reference to status and participation of group.
(ii) Determination of status and material participation of consolidated group.
(5) Modification of rules for identifying disallowed passive activity deductions and credits.
(i) Identification of disallowed deductions.
(ii) Ratable portion of disallowed passive activity loss.
(iii) Identification of disallowed credits.
(6) Transactions between members of a consolidated group.
(i) Scope.
(ii) Recharacterization of gain or loss from intercompany transactions other than deferred intercompany transactions.
(A) In general.
(B) Recharacterization of gain or loss as portfolio items.
(iii) Deferred intercompany transactions.
(A) In general.
(B) Deferred intercompany transactions involving property subject to depreciation, amortization, or depletion.
(C) Restoration of deferred gain or loss or dispositions.
(D) Certain recharacterized items treated as portfolio items.
(E) Property involved in deferred intercompany transaction.
(iv) Definitions.
(A) Deferred intercompany transaction.
(B) Directly related.
(C) Intercompany transaction.
(D) Purchasing member.
(E) Selling member.
(7) Disposition of stock of a member of an affiliated group.
(8) Dispositions of property used in multiple activities.
(i) [Reserved]
(j) Spouses filing joint return.
(1) In general.
(2) Exceptions to treatment as one taxpayer.
(i) Identification of disallowed deductions and credits.
(ii) Treatment of deductions disallowed under sections 704(d), 1366(d) and 465.
(iii) Treatment of losses from working interests.
(3) Joint return no longer filed.
(4) Participation of spouses.
(k) Former passive activities and changes in status of corporations. [Reserved]

§ 1.469-2T PASSIVE ACTIVITY LOSS (TEMPORARY).

(a) Scope of this section.
(b) Definition of passive activity loss.
(1) In general.
(2) Cross references.
(c) Passive activity gross income.
(1) In general.
(2) Treatment of gain from disposition of an interest in an activity or an interest in property used in an activity.
(i) In general.
(A) Treatment of gain.
(B) Dispositions of partnership interests and S corporation stock.
(C) Interest in property.
(D) Examples.
(ii) Disposition of property used in more than one activity in 12-month period preceding disposition.
(iii) Dispostion of substantially appreciated property formerly used in nonpassive activity.
(A) In general.
(B) Date of disposition.
(C) Substantially appreciated property.
(D) Coordination with paragraph (c)(2)(ii) of this section.
(E) Coordination with section 163(d).
(F) Example.
(3) Items of portfolio income specifically excluded.
(i) In general.
(ii) Gross income derived in the ordinary course of a trade or business.
(iii) Special rules.
(A) Income from property held for investment by dealer.
(B) Royalties derived in the ordinary course of the trade or business of licensing intangible property.
(*1*) In general.
(*2*) Substantial services or costs.
(*i*) In general.
(*ii*) Exception.
(*iii*) Expenditures taken into account.
(*3*) Passthrough entities.
(*4*) Cross reference.
(C) Mineral production payments.
(iv) Examples.
(4) Items of personal service income specifically excluded.
(i) In general.
(ii) Example.
(5) Income from section 481 adjustment.
(i) In general.
(ii) Positive section 481 adjustments.
(iii) Ratable portion.
(6) Gross income from certain oil or gas properties.
(i) In general.
(ii) Net income from the property.
(iii) Property.
(iv) Examples.
(7) Other items specifically excluded.
(d) Passive activity deductions.
(1) In general.
(2) Exceptions.
(3) Interest expense.
(4) Clearly and directly allocable expenses.
(5) Treatment of loss from disposition.
(i) In general.
(ii) Disposition of Property used in more than one activity in 12-month period preceding disposition.
(iii) Other applicable rules.

(A) Interest in property.

(B) Dispositions of partnership interests and S Corporation stock.

(6) Coordination with other limitations on deduction that apply before section 469.

(i) In general.

(ii) Proration of deductions disallowed under basis limitations.

(A) Deductions disallowed under section 704(d).

(B) Deductions disallowed under section 1366(d).

(iii) Proration of deductions disallowed under at-risk limitation.

(iv) Coordination of basis and at-risk limitations.

(v) Separately identified items of deduction and loss.

(7) Deductions from section 481 adjustment.

(i) In general.

(ii) Negative section 481 adjustment.

(iii) Ratable portion.

(8) Taxable year in which item arises.

(e) Special rules for partners and S corporation shareholders.

(1) In general.

(2) Payments under section 707(a), 707(c), and 736(b).

(i) Section 707(a).

(ii) Section 707(c).

(A) In general.

(B) Exception.

(iii) Section 736 (b).

(3) Sale or exchange of interest in passthrough entity.

(i) Application of this paragraph (e) (3).

(ii) General rule.

(A) Allocation among activities.

(B) Ratable portion.

(*1*) Dispositions on which gain is recognized.

(*2*) Dispositions on which loss is recognized.

(C) Default rule.

(D) Special rules.

(*1*) Applicable valuation date.

(*i*) In general.

(*ii*) 2Exception.

(*2*) Basis adjustments.

(*3*) Tiered passthrough entities.

(E) Meaning of certain terms.

(iii) Treatment of gain allocated to certain passive activities as not from a passive activity.

(iv) Dispositions occurring in taxable years beginning before February 19, 1988.

(A) In general.

(B) Exceptions.

(v) Treatment of portfolio assets.

(vi) Definitions.

(vii) Examples.

(f) Recharacterization of passive income in certain situations.

(1) In general.

(2) Special rule for significant participation.

(i) In general.

(ii) Significant participation passive activity.

(iii) Example.

(3) Rental of nondepreciable property.

(4) Net interest income from passive equity-financed lending activity.

(i) In general.

(ii) Equity-financed lending activity.

(A) In general.

(B) Certain liabilities not taken into account.

(iii) Equity-financed interest income.

(iv) Net interest income.

(v) Interest-bearing assets.

(vi) Liabilities incurred in the activity.

(vii) Average outstanding balance.

(viii) Example.

(5) Net income from certain property rented incidental to development activity.

(i) In general.

(ii) Commencement of use.

(iii) Services performed for the purpose of endhancing the value of property.

(iv) Example.

(6) Property rented to a nonpassive activity.

(7) Special rules applicable to the acquisition of an interest in a passthrough entity engaged in the trade or business of licensing intangible property.

(iv) In general.

(ii) Royalty income from property.

(iii) Exceptions.

(iv) Capital expenditures.

(v) Example.

(8) Limitation on recharacterized income.

(9) Meaning of certain terms.

(10) Coordination with section 163 (d).

(11) Effective date.

§ 1.469-3T PASSIVE ACTIVITY CREDIT (TEMPORARY).

(a) Computation of passive activity credit.

(b) Credits subject to section 469.

(1) In general.

(2) Treatment of credits attributable to qualified progress expenditures.

(3) Special rule for partners and S corporation shareholders.

(4) Exception for pre-1987 credits.

(c) Taxable year to which credit is attributable.

(d) Regular tax liability allocable to passive activities.

(1) In general.

(2) Regular tax liability.

(e) Coordination with section 39.

(f) Examples.

§ 1.469-4T DEFINITION OF ACTIVITY (TEMPORARY). [RESERVED]

§ 1.469-5T MATERIAL PARTICIPATION (TEMPORARY).

(a) In general.

(b) Facts and circumstances.

(1) In general. [Reserved]

(2) Certain participation insufficient to constitute material participation under this paragraph (b).

(i) Participation satisfying standards not contained in section 469.

(ii) Certain management activities.

(iii) Participation less than 100 hours.

(c) Significant participation activity.

(1) In general.

(2) Significant participation.

(d) Personal service activity.

(e) Treatment of limited partners.

(1) General rule.

(2) Exceptions.

(3) Limited Parntership interest.

(i) In general.

(ii) Limited Partner holding general partner interest.

(f) Participation.

(1) In general.

(2) Exceptions.

(i) Certain work not customarily done by owners.

(ii) Participation as an investor.

(A) In general.

(B) Work done in individual's capacity as an investor.

(3) Participation of spouse.

(4) Methods of proof.

(g) Material participation of trusts and estates. [Reserved]

(h) Miscellaneous rules.

(1) Participation of corporations.

(2) Treatment of certain retired farmers and surviving spouses of retired or disabled farmers.

(i) [Reserved]

(j) Material participation for taxable years beginning before January 1, 1987.

(k) Examples.

§ 1.469-6T TREATMENT OF LOSSES UPON CERTAIN DISPOSITIONS (TEMPORARY). [RESERVED]

§ 1.469-7T TREATMENT OF SELF-CHARGED ITEMS OF INCOME AND EXPENSE (TEMPORARY). [RESERVED]

§ 1.469-8T APPLICATION OF SECTION 469 TO TRUSTS, ESTATES, AND THEIR BENEFICIARIES (TEMPORARY). [RESERVED]

§ 1.469-9T TREATMENT OF INCOME, DEDUCTIONS, AND CREDITS FROM CERTAIN RENTAL REAL ESTATE ACTIVITIES (TEMPORARY). [RESERVED]

§ 1.469-10T APPLICATION OF SECTION 469 TO PUBLICLY TRADED PARTNERSHIPS (TEMPORARY). [RESERVED]

§ 1.469-11T EFFECTIVE DATE AND TRANSITION RULES (TEMPORARY).

(a) Effective date.

(1) In general.

(2) Application of certain income recharacterization rules.

(i) In general.

(ii) Property rented to a nonpassive activity.

(3) Qualified low-income housing projects.

(4) Effect of events occurring in years prior to 1987.

(5) Examples.

(b) Transitional rule for pre-enactment loss and pre-enactment credit.

(1) In general.

(2) Applicable percentage.

(3) Pre-enactment loss.

(4) Pre-enactment credit.

(5) Examples.

(c) Definitions of pre-enactment interest.

(1) General rule.

(2) Qualified interest.

(i) In general.

(ii) Stock in a C corporation.

(3) Pre-enactment activity.

(i) In general.

(ii) Character before 1987 irrelevant.

(4) Examples.

(5) Effect of changes in a taxpayer's interest in a pre-enactment activity.

(i) In general.

(ii) Partnership terminations under section 708(b)(1)(B).

(iii) Examples.

(6) Special rule for beneficiaries of trusts or estates.

(i) In general.

(ii) Interests distributed to beneficiaries.

(7) Written binding contract.

(i) In general.

(ii) Special rule for contract of partnership or S corporation.

(iii) Application of rule to partnership agreements.

§ 1.469–1T General rules (temporary).

(a) *Passive activity loss and credit disallowed*—(1) *In general.* Except as otherwise provided in paragraph (a)(2) of this section—

(i) The passive activity loss for the taxable year shall not be allowed as a deduction; and

(ii) The passive activity credit for the taxable year shall not be allowed.

(2) *Exceptions.* Paragraph (a)(1) of this section shall not apply to the passive activity loss or the passive activity credit for the taxable year to the extent provided in—

(i) Section 469(i) and the rules to be contained in § 1.469–9T (relating to losses and credits attributable to certain rental real estate activities); and

(ii) Section 1.469–11T (relating to losses and credits attributable to certain pre-enactment interests in activities).

(b) *Taxpayers to whom these rules apply.* The rules of section 469 and the regulations thereunder generally apply to—

(1) Individuals;

(2) Trusts (other than trusts (or portions of trusts) described in section 671);

(3) Estates;

(4) Personal service corporations (within the meaning of paragraph (g)(2)(i) of this section); and

(5) Closely held corporations (within the meaning of paragraph (g)(2)(ii) of this section).

(c) *Cross references*—(1) *Definition of "passive activity."* Rules relating to the definition of the term "passive activity" are contained in paragraph (e) of this section.

(2) *Passive activity loss.* Rules relating to the computation of the passive activity loss for the taxable year are contained in § 1.469–2T.

(3) *Passive activity credit.* Rules relating to the computation of the passive activity credit for the taxable year are contained in § 1.469–3T.

(4) *Effect of rules for other purposes.* Rules relating to the effect of section 469 and the regulations thereunder for other purposes under the Code are contained in paragraph (d) of this section.

(5) *Special rule for oil and gas working interests.* Rules relating to the treatment of losses and credits from certain interests in oil and gas wells are contained in paragraph (e)(4) of this section

(6) *Treatment of disallowed losses and credits.* Paragraph (f) of this section contains rules relating to—

(i) The treatment of deductions from passive activities in taxable years in which the passive activity loss is disallowed in whole or in part under paragraph (a)(1)(i) of this section; and

(ii) The treatment of credits from passive activities in taxable years in which the passive activity credit is disallowed in whole or in part under paragraph (a)(1)(ii) of this section.

(7) *Corporation subject to section 469.* Rules relating to the application of section 469 and regulations thereunder to C corporations are contained in paragraph (g) of this section.

(8) *Consolidated groups.* Rules relating to the application of section 469 and the regulations thereunder to affiliated groups of corporations filing a consolidated return for the taxable year are contained in paragraph (h) of this section.

(9) *Joint returns.* Rules relating to the application of section 469 and the regulations thereunder to spouses filing a joint return for the taxable year are contained in paragraph (j) of this section.

(10) *Material participation.* Rules defining the term "material participation" are contained in § 1.469–5T.

(11) *Effective date and transition rules.* Rules relating to the effective date of section 469 and the regulations thereunder and transition rules applicable to pre-enactment interests in activities are contained in § 1.469–11T.

(12) *Future regulations.* (i) Rules relating to former passive activities and changes in corporate status will be contained in paragraph (k) of this section.

(ii) Rules relating to the definition of "activity" will be contained in § 1.469–4T.

(iii) Rules relating to the treatment of deductions from activities that are disposed of in certain transactions will be contained in § 1.469–6T.

(iv) Rules relating to the treatment of self-charged items of income and expense will be contained in § 1.469–7T.

(v) Rules relating to the application of section 469 and the regulations thereunder to trusts, estates, and their beneficiaries will be contained in § 1.469–8T.

(vi) Rules relating to the treatment of income, deductions, and credits from certain rental real estate activities of individuals and certain estates will be contained in § 1.469–9T.

(vii) Rules relating to the application of section 469 to publicly traded partnerships will be contained in § 1.469–10T.

(d) *Effect of section 469 and the regulations thereunder for other purposes*—(1) *Treatment of items of passive activity income and gain.* Neither the provisions of section 469 (a) (1) and paragraph (a)(1) of this section nor the characterization of items of income or deduction as passive activity gross income (within the meaning of § 1.469–2T (c)) or passive activity deductions (within the meaning of § 1.469–2T (d)) affects the treatment of any item of income or gain under any provision of the Internal Revenue Code other than section 469. The following example illustrates the application of this paragraph (d)(1):

Example. (i) In 1991, an individual's only income and loss from passive activities are a $10,000 capital gain from passive activity ª and a $12,000 ordinary loss from passive activity Y. The taxpayer also has a $10,000 capital loss that is not derived from a passive activity.

(ii) Under § 1.469–2T (b), the taxpayer has a $2,000 passive activity loss for the taxable year. The only effect of section 469 and the regulations thereunder is to disallow a deduction for the taxpayer's $2,000 passive activity loss for the taxable year. Thus, the taxpayer's capital loss for the taxable year is allowed because the $10,000 capital gain from passive activity ª is taken into account under section 1211 (b) in computing the taxpayer's allowable capital loss for the year.

(2) *Coordination with section 1211.* A passive activity deduction that is not disallowed for the taxable year under section 469 and the regulations thereunder may nonetheless be disallowed for the taxable year under section 1211. The following example illustrates the application of this paragraph (d)(2):

Example. In 1987, an individual derives $10,000 of ordinary income from passive activity X, no gains from the sale or exchange of captial assets or assets used in a trade or business, $12,000 of capital loss from passive activity Y, and no income, gain, deductions, or losses from any other passive activity. The capital loss from activity Y is a passive activity deduction (within the meaning of § 1.469–2T(d)). Under section 469 and the regulations thereunder, the taxpayer is allowed $10,000 of the $12,000 passive activity deduction and has a $2,000 passive activity loss for the taxable year. Since the $10,000 passive activity deduction allowed under section 469 is a capital loss, such deduction is allowable for the taxable year only to the extent provided under section 1211.

Therefore, the taxpayer is allowed $3,000 of the $10,000 capital loss under section 1211 and has a $7,000 capital loss carryover (within the meaning of section 1212 (b)) to the succeeding taxable year.

(3) *Treatment of passive activity losses.* Except as otherwise provided by regulations, a deduction that is disallowed for a taxable year under section 469 and the regulations thereunder is not taken into account as a deduction that is allowed for the taxable year in computing the amount subject to any tax imposed by subtitle A of the Internal Revenue Code. The following example illustrates the application of this paragraph (d)(3):

Example. An individual has a $5,000 passive activity loss for a taxable year, all of which is disallowed under paragraph (a)(1) of this section. All of the disallowed loss is allocated under paragraph (f) of this section to activities that are trades or businesses (within the meaning of section 1402(c)). Such loss is not taken into account for the taxable year in computing the taxpayer's taxable income subject to tax under section 1. In addition, under this paragraph (d)(3), such loss is not taken into account for the taxable year in computing the taxpayer's net earnings from self-employment subject to tax under section 1401.

(e) *Definition of "passive activity"*—(1) *In general.* Except as otherwise provided in this paragraph (e), an activity is a passive activity of the taxpayer for a taxable year if and only if the activity—

(i) Is a trade or business activity (within the meaning of paragraph (e)(2) of this section) in which the taxpayer does not materially participate for such taxable year; or

(ii) Is a rental activity (within the meaning of paragraph (e) (3) of this section), without regard to whether or to what extent the taxpayer participates in such activity.

(2) *Trade or business activity*—(i) *In general.* An activity is a trade or business activity for a taxable year if for such year—

(A) (*1*) The activity involves the conduct of a trade or business (within the meaning of section 162);

(*2*) Research or experimental expenditures paid or incurred with respect to the activity are deductible under section 174 (or would be deductible if the taxpayer adopted the method described in section 174(a)); or

(*3*) The activity is described in paragraph (e)(2)(ii) of this section; and

(B) The activity is not a rental activity or an activity involving the rental of property described in paragraph (e)(3) (vi)(B) of this section.

(ii) *Certain activities not involving the conduct of a trade or business treated as trade or business activities.* [Reserved]

(3) *Rental activity*—(1) *In general.* Except as otherwise provided in this paragraph (e)(3), an activity is a rental activity for a taxable year if—

(A) During such taxable year, tangible property held in connection with the activity is used by customers or held for use by customers; and

(B) The gross income attributable to the conduct of the activity during such taxable year represents (or, in the case of an activity in which property is held for use by customers, the expected gross income from the conduct of the activity will represent) amounts paid or to be paid principally for the use of such tangible property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

(ii) *Exceptions.* For purposes of this paragraph (e)(3), an activity involving the use of tangible property is not a rental activity for a taxable year if for such taxable year—

(A) The average period of customer use for such property is seven days or less;

(B) The average period of customer use for such property is 30 days or less, and significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) are provided by or on behalf of the owner of the property in connection with making the property available for use by customers;

(C) Extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use);

(D) The rental of such property is treated as incidental to a nonrental activity of the taxpayer under paragraph (e)(3)(vi) of this section;

(E) The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers; or

(F) The provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest is not a rental activity under paragraph (e)(3)(vii) of this section.

(iii) *Average period of customer use.* For purposes of this paragraph (e)(3), the average period of customer use for property held in connection with an activity is determined for a taxable year by dividing—

(A) The aggregate number of days in all periods of customer use for such property ending during the taxable year; by

(B) The number of such periods of customer use.

For this purpose, each period during which a customer has a continuous or recurring right to use an item of property held in connection with the activity (without regard to whether the customer uses the property for the entire period or whether such right to use the property is pursuant to a single agreement or to renewals thereof) is treated as a separate period of customer use.

(iv) *Significant personal services*—(A) *In general.* For purposes of paragraph (e)(3)(ii)(B) of this section, personal services include only services performed by individuals, and do not include excluded services (within the meaning of paragraph (e)(3)(iv)(B) of this section). In determining whether personal services provided in connection with making property available for use by customers are significant, all of the relevant facts and circumstances shall be taken into account. Relevant facts and circumstances include the frequency with which such services are provided, the type and amount of labor required to perform such services, and the value of such services relative to the amount charged for the use of the property.

(B) *Excluded services.* For purposes of paragraph (e)(3)(iv)(A) of this section, the term "excluded services" means, with respect to any property made available for use by customers—

(*1*) Services necessary to permit the lawful use of the property;

(*2*) Services performed in connection with the construction of improvements to the property, or in connection with the performance of repairs that extend the property's useful life for a period substantially longer than the average period for which such property is used by customers; and

(*3*) Services, provided in connection with the use of any improved real property, that are similar to those commonly provided in connection with long-term rentals of high-grade commercial or residential real property (e.g., cleaning and maintenance of common areas, routine repairs, trash collection, elevator service, and security at entrances or perimeters).

(v) *Extraordinary personal services.* For purposes of paragraph (e)(3)(ii)(C) of this section, extraordinary personal services are provided in connection with making property available for use by customers only if the services provided in connection with the use of the property are performed by individuals, and the use by customers of the property is incidental to their receipt of such services. For example, the use by patients of a hospital's boarding facilities generally is incidental to their receipt of the personal services provided by the hospital's medical and nursing staff. Similarly, the use by students of a boarding school's dormitories generally is incidental to their receipt of the personal services provided by the school's teaching staff.

(vi) *Rental of property incidental to a nonrental activity of the taxpayer*—(A) *In general.* For purposes of paragraph (e)(3)(ii)(D) of this section, the rental of property shall be treated as incidental to a nonrental activity of the taxpayer only to the extent provided in this paragraph (e)(3)(vi).

(B) *Property held for investment.* The rental of property during a taxable year shall be treated as incidental to an activity of holding such property for investment if and only if—

(*1*) The principal purpose for holding the property during such taxable year is to realize gain from the appreciation of the property (without regard to whether it is expected that such gain will be realized from the sale or exchange of the property in its current state of development); and

(*2*) The gross rental income from the property for such taxable year is less than two percent of the lesser of—

(*i*) The unadjusted basis of such property; and

(*ii*) The fair market value of such property.

(C) *Property used in a trade or business.* The rental of property during a taxable year shall be treated as incidental to a trade or business activity (within the meaning of paragraph (e)(2) of this section) if and only if—

(*1*) The taxpayer owns an interest in such trade or business activity during the taxable year;

(*2*) The property was predominantly used in such trade or business activity during the taxable year or during at least two of the five taxable years that immediately precede the taxable year; and

(*3*) The gross rental income from such property for the taxable year is less than two percent of the lesser of—

(*i*) The unadjusted basis of such property; and

(*ii*) The fair market value of such property.

(D) *Property held for sale to customers.* The rental of property during the taxable year in which the property is sold or exchanged (in a transaction in which gain or loss is recognized) shall be treated as incidental to an activity of dealing in such property if at the time of the sale or exchange the property is held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business of the taxpayer (within the meaning of section 1221(1)).

(E) *Lodging rented for convenience of employer.* The provision of lodging to an employee or to an employee's spouse or dependents shall be treated as incidental to the activity (or activities) of the taxpayer in which the employee performs services if such lodging is furnished for the taxpayer's convenience (within the meaning of section 119).

(F) *Unadjusted basis.* For purposes of this paragraph (e)(3)(vi), the term "unadjusted basis" means adjusted basis determined without regard to any adjustment described in section 1016 that decreases basis.

(vii) *Property made available for use in a nonrental activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.* If the taxpayer owns an interest in a partnership, S corporation, or joint venture conducting an activity other than a rental activity, and the taxpayer provides property for use in the activity in the taxpayer's capacity as an owner of an interest in such partnership, S corporation, or joint venture, the provision of such property is not a rental activity. Thus, if a partner contributes the use of property to a partnership, none of the partner's distributive share of partnership income is income from a rental activity unless the partnership is engaged in a rental activity. In addition, a partner's gross income attributable to a payment described in section 707(c) is not income from a rental activity under any circumstances (see § 1.469-2T (e)(2)). The determination of whether property used in an activity is provided by the taxpayer in the taxpayer's capacity as an owner of an interest in a partnership, S corporation, or joint venture shall be made on the basis of all of the facts and circumstances.

(viii) *Examples.* The following examples illustrate the application of this paragraph (e)(3):

Example (1). The taxpayer is engaged in an activity of leasing photocopying equipment. The average period of customer use for the equipment exceeds 30 days. Pursuant to the lease agreements, skilled technicians employed by the taxpayer maintain the equipment and service malfunctioning equipment for no additional charge. Service calls occur frequently (three times per week on average) and require substantial labor. The value of the maintenance and repair services (measured by the cost to the taxpayer of employees performing these services) exceeds 50 percent of the amount charged for the use of the equipment. Under these facts, services performed by individuals are provided in connection with the use of the photocopying equipment, but the customers' use of the photocopying equipment is not incidental to their receipt of the services. Therefore, extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are not provided in connection with making the photocopying equipment available for use by customers, and the activity is a rental activity.

Example (2). The facts are the same as in example (1), except that the average period of customer use for the photocopying equipment exceeds seven days but does not exceed 30 days. Under these facts, significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) are provided in connection with making the photocopying equipment available for use by customers and, under paragraph (e)(3)(ii)(B) of this section, the activity is not a rental activity.

Example (3). The taxpayer is engaged in an activity of transporting goods for customers. In conducting the activity, the taxpayer provides tractor-trailers to transport goods for customers pursuant to arrangements under which the tractor-trailers are selected by the taxpayer, may be replaced at the sole option of the taxpayer, and are operated and maintained by drivers and mechanics employed by the taxpayer. The average period of customer use for the tractor-trailers exceeds 30 days. Under these facts, the use of tractor-trailers by the taxpayer's customers is incidental to their receipt of personal services provided by the taxpayer. Accordingly, the services performed in the activity are extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) and, under paragraph (e)(3)(ii)(C) of this section, the activity is not a rental activity.

Example (4). The taxpayer is engaged in an activity of owning and operating a residential apartment hotel. For the taxable year, the average period of customer use for apartments exceeds seven days but does not exceed 30 days. In addition to cleaning public entrances, exists, stairways, and lobbies, and collecting and removing trash, the taxpayer provides a daily maid and linen service at no additional charge. All of the services other than maid and linen service are excluded services (within the meaning of paragraph (e)(3)(iv)(B) of this section), because such services are similar to those commonly provided in connection with long-term rentals of high-grade residential real property. The value of the maid and linen services (measured by the cost to the taxpayer of employees performing such services) is less than 10 percent of the amount charged to tenants for occupancy of apartments. Under these facts, neither significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) nor extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are provided in connection with making apartments available for use by customers. Accordingly, the activity is a rental activity.

Example (5). The taxpayer owns 1,000 acres of unimproved land with a fair market value of $350,000 and an unadjusted basis of $210,000. The taxpayer holds the land for the principal purpose of realizing gain from appreciation. In order to defray the cost of carrying the land, the taxpayer leases the land to a rancher, who uses the land to graze cattle and pays rent of $4,000 per year. Thus, the gross rental income from the land is less than two percent of the lesser of the fair market value and the unadjusted basis of the land (.02x$210,000=$4,200). Accordingly, under paragraph (e)(3)(ii)(D) of this section, the rental of the land is not a rental activity because the rental is treated under paragraph (e)(3)(vi)(B) of this section as incidental to an activity of holding the property for investment.

Example (6). (i) A calendar year taxpayer owns an interest in a farming activity which is a trade or business activity (within the meaning of paragraph (e)(2) of this section) and owns farmland which was used in the farming activity in 1985 and 1986. The fair market value of the farmland is $350,000 and its unadjusted basis is $210,000. In 1987, 1988, and 1989, the taxpayer continues to own an interest in the farming activity but does not use the land in the activity. In 1987, the taxpayer leases the land for $4,000 to a rancher, who uses the land to graze cattle. In 1988, the taxpayer leases the land for $10,000 to a film production company, which uses the land to film scenes for a movie. In 1989, the taxpayer again leases the land for $4,000 to the rancher.

(ii) For 1987 and 1989, the taxpayer owns an interest in a trade or business activity, and the farmland which the taxpayer leases to the rancher was used in such activity for two out of the five immediately preceding taxable years. In addition, the gross rental income from the land ($4,000) is less than two percent of the lesser of the fair market value and the unadjusted basis of the land (.02x$210,000=$4,200). Accordingly, the taxpayer's rental of the land is treated under paragraph (e)(3)(vi)(C) of this section as incidental to the taxpayer's farming activity, and is not a rental activity.

(iii) Because the taxpayer's gross rental income from the land for 1988 ($10,000) is not less than two percent of the lesser of the fair market value and the unadjusted basis of the land, the requirement of paragraph (e)(3)(vi)(C)(*3*) of this section is not met. Therefore, the taxpayer's rental of the land in 1988 is not treated as incidental to the taxpayer's farming activity and is a rental activity.

Example (7). (i) In 1988, the taxpayer acquires vacant land for the purpose of constructing a shopping mall. Before commencing construction, the taxpayer leases the land under a one-year lease to an automobile dealer, who uses the land to park cars held in its inventory. The taxpayer commences construction of the shopping mall in 1989.

(ii) The taxpayer acquired the land for the principal purpose of constructing the shopping mall, not for the principal purpose or realizing gain from the appreciation of the property. Therefore, the rental of the property in 1988 is not treated under paragraph (e)(3)(vi)(B) of this section as incidental to an activity of holding the property for investment.

(iii) The land has not been used in any taxable year in any trade or business of the taxpayer. Therefore, the rental of the property in 1988 is not treated under paragraph (e)(3)(vi)(C) of this section as incidental to a trade or business activity.

(iv) Since the rental of the land in 1988 is not treated under paragraph (e)(3)(vi) of this section as incidental to a nonrental activity of the taxpayer, the rental of the land in 1988 is a rental activity. See § 1.469-2T(f)(3) for a special rule relating to the treatment of gross income from the rental of nondepreciable property.

Example (8). The taxpayer makes farmland available to a tenant farmer pursuant to an arrangement designated a "crop-share lease." Under the arrangement, the tenant is required to use the tenant's best efforts to farm the land and produce marketable crops. The taxpayer is obligated to pay 50 percent of the costs incurred in the activity (without regard to whether any crops are successfully produced or marketed), and is entitled to 50 percent of the crops produced (or 50 percent of the proceeds from marketing the crops). For purposes of paragraph (e)(3)(vii) of this section, the taxpayer is treated as providing the farmland for use in a farming activity conducted by a joint venture in the taxpayer's capacity as an owner of an interest in the joint venture. Accordingly, under paragraph (e)(3)(ii)(F) of this section, the taxpayer is not engaged in a rental activity, without regard to whether the taxpayer performs any services in the farming activity.

Example (9). The taxpayer owns a taxicab which the taxpayer operates during the day and leases to another driver for use at night under a one-year lease. Under the terms of the lease, the other driver is charged a fixed rental for use of the taxicab. Assume that, under the rules to be contained in § 1.469-4T, the taxpayer is engaged in two separate activities, an activity of operating the taxicab and an activity of making the taxicab available for use by the other driver. Under these facts, the period for which the other driver uses the taxicab exceeds 30 days, and the taxpayer does not provide extraordinary personal services in connection with making the taxicab available to the other driver. Accordingly, the lease of the taxicab is a rental activity.

Example (10). The taxpayer operates a golf course. Some customers of the golf course pay green fees upon each use of the golf course, while other customers purchase weekly, monthly, or annual passes. The golf course is open to all customers from sunrise to sunset every day of the year except certain holidays and days on which the taxpayer determines that the course is to wet for play. The taxpayer thus makes the golf course available during prescribed hours for nonexclusive use by various customers. Accordingly, under paragraph (e)(3)(ii)(E) of this section, the taxpayer is not engaged in a rental activity, without regard to the average period of customer use for the golf course.

(4) *Special rule for oil and gas working interests*—(i) *In general.* Except as otherwise provided in paragraph (e)(4)(ii) of this section, an interest in an oil or gas well drilled or operated pursuant to a working interest (within the meaning of paragraph (e)(4)(iv) of this section) of a taxpayer is not an interest in a passive activity for the taxpayer's taxable year (without regard to whether the taxpayer materially participates in such activity) if at any time during such taxable year the taxpayer holds such working interest either—

(A) Directly; or

(B) Through an entity that does not limit the liability of the taxpayer with respect to the drilling or operation of such well pursuant to such working interest.

(ii) *Exception for deductions attributable to a period during which liability is limited*—(A) *In general.* If paragraph (e)(4)(i) of this section applies for a taxable year to the taxpayer's interest in an oil or gas well that would, but for the application of paragraph (e)(4)(i) of this section, by an interest in a passive activity for the taxable year, and the taxpayer has a net loss (within the meaning of paragraph (e)(4)(ii)(C)(*3*) of this section) from the well for the taxable year—

(*1*) The taxpayer's disqualified deductions (within the meaning of paragraph (e)(4)(ii)(C)(*2*) of this section) from such oil or gas well for such year shall be treated as passive activity deductions for such year (within the meaning of § 1.469-2T(d)); and

(*2*) A ratable portion (within the meaning of paragraph (e)(4)(ii)(C)(*4*) of this section) of the taxpayer's gross income from such oil or gas well for such year shall be treated as passive activity gross income for such year (within the meaning of § 1.469-2T(c)).

(B) *Coordination with rules governing the identification of disallowed passive activity deductions.* If gross income and deductions from an activity for a taxable year are treated as passive activity gross income and passive activity deductions under paragraph (e)(4)(ii)(A) of this section, such activity shall be treated as a passive activity for such year for purposes of applying paragraph (f) (2) and (4) of this section.

(C) *Meaning of certain terms.* For purposes of this paragraph (e)(4)(ii), the following terms shall have the meanings set forth below:

(*1*) *Allocable deductions.* The deductions allocable to a taxable year are any deductions that arise in such year (within the meaning of § 1.469-2T (d)(8)) and any deductions that are treated as deductions for such year under paragraph (f)(4) of this section.

(*2*) *Disqualified deductions.* The taxpayer's "disqualified deductions" from an oil or gas well for a taxable year are the taxpayer's deductions—

(*i*) That are attributable to such well and allocable to the taxable year; and

(*ii*) With respect to which economic performance (within the meaning of section 461(h), without regard to section 461 (h)(3) or (i)(2)) occurs at a time during which the taxpayer's only interest in the working interest is held through an entity that limits the taxpayer's liability with respect to the drilling or operation of such well.

(*3*) *Net loss.* The "net loss" of a taxpayer from an oil or gas well for a taxable year equals the amount by which the taxpayer's deductions that are attributable to such oil or gas well and allocable to such year exceeds the gross income of the taxpayer from such well for such year.

(*4*) *Ratable portion.* The "ratable portion" of the taxpayer's gross income from an oil or gas well for a taxable year equals the total amount of such gross income multiplied by the fraction obtained by dividing—

(*i*) The disqualified deductions from such oil or gas well for the taxable year; by

(*ii*) The total amount of the deductions that are attributable to such oil or gas well and allocable to the taxable year.

(iii) *Examples.* The following examples illustrate the application of paragraphs (e)(4) (i) and (ii) of this section:

Example (1). (i) A, a calendar year individual, acquires on January 1, 1987, a general partnership interest in P, a calendar year partnership that holds a working interest in an oil or gas property. Pursuant to the partnership agreement, A is entitled to convert the general partnership interest into a limited partnership interest at any time. On December 1, 1987, pursuant to a contract with D, an independent drilling contractor, P commences drilling a single well pursuant to the working interest. Under the drilling contract, P pays D for the drilling only as the work is performed. All drilling costs are deducted by P in the year in which they are paid. At the end of 1987, A converts the general partnership interest into a limited partnership interest, effective immediately. The drilling of the well is completed on February 28, 1988. A's interest in the well would but for this paragraph (e)(4) be an interest in a passive activity.

(ii) Throughout 1987, A holds the working interest through an entity that does not limit A's liability with respect to the drilling of the well pursuant to the working interest. In 1988, however, A holds the working interest through an entity that limits A's liability with respect to the drilling and operation of the well throughout such year. Accordingly, under paragraph (e)(4)(i) of this section, A's interest in P's well is not an interest in a passive activity for 1987 but is an interest in a passive activity for 1988. Moreover, since economic performance occurs in 1987 with respect to all items of deduction for drilling costs that are allocable to 1987, A has no disqualified deductions for 1987.

Example (2). The facts are the same as in example (1), except that all costs of drilling under the contract with D (including costs of drilling performed after 1987) are paid before the end of 1987 and A has a net loss for 1987. In addition, A has $15,000 of total deductions that are attributable to the well and allocable to 1987, but economic performance (as that term is used in paragraph (e)(4)(ii)(C)(*2*)(*ii*) of this section) does not occur with respect to $5,000 of those deductions until 1988. Under paragraph (e)(4)(ii) of this section, the $5,000 of deductions with respect to which economic performance occurs in 1988 are disqualified deductions and are treated as passive activity deductions for 1987. In addition, one-third ($5,000/$15,000) of A's gross income from the well for 1987 is treated as passive activity gross income.

(iv) *Definition of "working interest."* For purposes of section 469 and the regulations thereunder, the term "working interest" means an operating mineral interest (within the meaning of section 614(d) and the regulations thereunder).

(v) *Entities that limit liability*—(A) *General rule.* For purposes of paragraph (e)(4)(i)(B) of this section, an entity limits the liability of the taxpayer with respect to the drilling or operation of a well pursuant to a working interest held through such entity if the taxpayer's interest in the entity is in the form of—

(*1*) A limited partnership interest in a partnership in which the taxpayer is not a general partner;

(*2*) Stock in a corporation; or

(*3*) An interest in any entity (other than a limited partnership or corporation) that, under applicable State law, limits the potential liability of a holder of such an interest for all obligations of the entity to a determinable fixed amount (for example, the sum of the taxpayer's capital contributions).

(B) *Other limitations disregarded.* For purposes of this paragraph (e)(4), protection against loss through any of the following is not taken into account in determining whether a taxpayer holds a working interest through an entity that limits the taxpayer's liability:

(*1*) An indemnification agreement;

(*2*) A stop loss arrangement;

(*3*) Insurance;

(*4*) Any similar arrangement; or

(*5*) Any combination of the foregoing.

(C) *Examples.* The following examples illustrate the application of this paragraph (e)(4)(v):

Example (1). A owns a 20 percent interest as a general partner in the capital and profits of P, a partnership which owns oil or gas working interests. The other partners of P agree to indemnify A against liability in excess of A's capital contribution for any of P's costs and expenses with respect to P's working interests. As a general partner, however, A is jointly and severally liable for all of P's liabilities and, under paragraph (e)(4)(v)(B)(*1*) of this section, the indemnification agreement is not taken into account in determining whether A holds the working interests through an entity that limits A's liability. Accordingly, the partnership does not limit A's liability with respect to the drilling or operation of wells pursuant to the working interests.

Example (2). B owns a 10 percent interest in X, an entity (other than a limited partnership or corporation) created under applicable State law to hold working interests in oil or gas properties. Under applicable State law, B is liable without limitation for 10 percent of X's costs and expenses with respect to X's working interests but is not liable for the remaining 90 percent of such costs and expenses. Since B's liability for the obligations of X is not limited to a determinable fixed amount (within the meaning of paragraph (e)(4)(v)(A)(*3*) of this section), the entity does not limit B's liability with respect to the drilling or operation of wells pursuant to the working interests.

Example (3). C is both a general partner and a limited partner in a partnership that owns a working interest in oil or gas property. Because C owns an interest as a general partner in each well drilled pursuant to the working interest, C's entire interest in each well drilled pursuant to the working interest is treated under paragraph(e)(4)(i) of this section as an interest in an activity that is not a passive activity (without regard to whether C materially participates in such activity).

(vi) *Cross reference to special rule for income from certain oil or gas properties.* A special rule relating to the treatment of income from certain interests in oil or gas properties is contained in § 1.469-2T(c)(6).

(5) *Rental of dwelling unit.* An activity involving the rental of a dwelling unit that is used as a residence by the taxpayer during the taxable year (within the meaning of section 280A(c)(5)) is not a passive activity of the taxpayer for such year.

(6) *Activity of trading personal property*—(i) *In general.* An activity of trading personal property for the account of owners of interests in the activity is not a passive activity (without regard to whether such activity is a trade or business activity (within the meaning of paragraph (e)(2) of this section)).

(ii) *Personal property.* For purposes of this paragraph (e)(6), the term "personal property" means personal property (within the meaning of section 1092(d), without regard to paragraph (3) thereof).

(iii) *Example.* The following example illustrates the application of this paragraph (e)(6):

Example. A partnership is a trader of stocks, bonds, and other securities (within the meaning of section 1236(c)). The capital employed by the partnership in the trading activity consists of amounts contributed by the partners in exchange for their partnership interests, and funds borrowed by the partnership. The partnership derives gross income from the activity in the form of interest, dividends, and capital gains. Under these facts, the partnership is treated as conducting an activity of trading personal property for the account of its partners. Accordingly, under this paragraph (e)(6), the activity is not a passive activity.

(f) *Treatment of disallowed passive activity losses and credits*—(1) *Scope of this paragraph.* The rules in this paragraph (f)—

(i) Identify the passive activity deductions that are disallowed for any taxable year in which all or a portion of the taxpayer's passive activity loss is disallowed under paragraph (a)(1)(i) of this section;

(ii) Identify the credits from passive activities that are disallowed for any taxable year in which all or a portion of the taxpayer's passive activity credit is disallowed under paragraph (a)(1)(i) of this section; and

(iii) Provide for the carryover of disallowed deductions and credits.

(2) *Identification of disallowed passive activity deductions*—(i) *Allocation of disallowed passive activity loss among activities*—(A) *General rule.* If all or any portion of the taxpayer's passive activity loss is disallowed for the taxable year under paragraph (a)(1)(i) of this section, a ratable portion of the loss (if any) from each passive activity of the taxpayer is disallowed. For purposes of the preceding sentence, the ratable portion of a loss from an activity is computed by multiplying the passive activity loss that is disallowed for the taxable year by the fraction obtained by dividing—

(*1*) The loss from the activity for the taxable year; by

(*2*) The sum of the losses for the taxable year from all activities having losses for such year.

(B) *Loss from an activity.* For purposes of this paragraph (f)(2)(i), the term "loss from an activity" means—

(*1*) The amount by which the passive activity deductions from the activity for the taxable year (within the meaning of § 1.469-2T(d)) exceed the passive activity gross income from the activity for the taxable year (within the meaning of § 1.469-2T(c)); reduced by

(*2*) Any part of such amount that is allowed under section 469(i) and the rules to be contained in § 1.469-9T (relating to the $25,000 allowance for certain rental real estate activities).

(C) *Significant participation passive activities.* If the taxpayer's passive activity gross income from significant participation passive activities (within the meaning of § 1.469-2T(f) (2)(ii)) for the taxable year (determined without regard to § 1.469-2T(f)(2) through (4)) exceeds the taxpayer's passive activity deductions from such activities for the taxable year, such activities shall be treated, solely for purposes of applying this paragraph (f)(2)(i) for the taxable year, as a single activity that does not have a loss for such taxable year.

(D) *Examples.* The following examples illustrate the application of this paragraph (f)(2)(i):

Example (1). An individual holds interests in three passive activities, A, B, and C. The gross income and deductions from these activities for the taxable year are as follows:

	A	B	C	Total
Gross income	$7,000	$4,000	$12,000	$23,000
Deductions	(16,000)	(20,000)	(8,000)	(44,000)

	A	B	C	Total
Net income (loss)	($9,000)	($16,000)	$4,000	($21,000)

The taxpayer's $21,000 passive activity loss for the taxable year is disallowed under paragraph (a)(1)(i) of this section. Therefore, a ratable portion of the losses from activities A and B is disallowed. The disallowed portion of each loss is determined as follows:

A: $21,000 × $9,000/$25,000	$7,560
B: $21,000 × $16,000/$25,000	$13,440
Total	$21,000

Example (2). An individual holds interests in four passive activities, A, B, C, and D. The results of operations of these activities for the taxable year are as follows:

	A	B	C	D	Total
Gross income	15,000	5,000	10,000	10,000	40,000
Deductions	(5,000)	(10,000)	(20,000)	(8,000)	(43,000)
Net income (loss)	10,000	(5,000)	(10,000)	2,000	(3,000)

Activities A and B are significant participation passive activities (within the meaning of § 1.469-2T(f)(2)(ii)). The gross income from these activities for the taxable year ($20,000) exceeds the passive activity deductions from those activities for the taxable year ($15,000) by $5,000 and, under § 1.469-2T(f)(2), $5,000 of gross income from those activities is treated as not from a passive activity. Therefore, solely for purposes of applying this paragraph (f)(2)(i) for the taxable year, activities A and B are treated as a single activity that does not have a loss for the taxable year. Under § 1.469-2T(b), the taxpayer's passive activity loss for the taxable year is $8,000 ($43,000 of passive activity deductions minus $35,000 of passive activity gross income). The results of treating activities A and B as a single activity that does not have a loss for the taxable year is that none of the $8,000 passive activity loss is allocated under this paragraph (f)(2)(i) to activity B for the taxable year, even though the taxpayer incurred a loss in that activity for the taxable year.

(ii) *Allocation within loss activities*—(A) *In general.* If all or any portion of a taxpayer's loss from an activity is disallowed under paragraph (f)(2)(i) of this section for the taxable year, a ratable portion of each passive activity deduction (other than an excluded deduction (within the meaning of paragraph (f)(2)(ii)(B) of this section)) of the taxpayer from such activity is disallowed. For purposes of the preceding sentence, the ratable portion of a passive activity deduction of a taxpayer is the amount of the disallowed portion of the taxpayer's loss from the activity (within the meaning of paragraph (f)(2)(i)(B) of this section) for the taxable year multiplied by the fraction obtained by dividing—

(*1*) The amount of such deduction; by

(*2*) The sum of all passive activity deductions (other than excluded deductions (within the meaning of paragraph (f)(2)(ii)(B) of this section)) of the taxpayer from such activity from the taxable year.

(B) *Excluded deductions.* The term "excluded deduction" means any passive activity deduction of a taxpayer that is taken into account in computing the taxpayer's net income from an item of property for a taxable year in which an amount of the taxpayer's gross income from such item of property is treated as not from a passive activity under § 1.469-2T(c)(6) or § 1.469-2T(f) (5), (6), or (7).

(iii) *Separately identified deductions.* In identifying the deductions from an activity that are disallowed under this paragraph (f)(2), the taxpayer need not account separately for a deduction unless such deduction may, if separately taken into account, result in an income tax liability for any taxable year different from that which would result were such deduction not taken into account separately. For related rules applicable to partnerships and S corporations, see § 1.702-1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Deductions that must be accounted for separately include (but are not limited to) deductions that—

(A) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in taxable years in which the taxpayer actively participates (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in such activity;

(B) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in taxable years in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in such activity; or

(C) Are taken into account under section 1211 (relating to the limitation on capital losses) or section 1231 (relating to property used in a trade or business and involuntary conversions).

(3) *Identification of disallowed credits from passive activities*—(i) *General rule.* If all or any portion of the taxpayer's passive activity credit is disallowed for the taxable year under paragraph (a)(1)(ii) of this section, a ratable portion of each credit from each passive activity of the taxpayer is disallowed. For purposes of the preceding sentence, the ratable portion of a credit of a taxpayer is computed by multiplying the portion of the taxpayer's passive activity credit that is disallowed for the taxable year by the fraction obtained by dividing—

(A) The amount of the credit; by

(B) The sum of all of the taxpayer's credits from passive activities for the taxable year.

(ii) *Coordination rule.* For purposes of paragraph (f)(3)(i) of this section, the credits from a passive activity do not include any credit or portion of a credit that—

(A) Is allowed for the taxable year under section 469(i) and the rules to be contained in § 1.469-9T (relating to the $25,000 allowance for certain rental real estate activities); or

(B) Increases the basis of property during the taxable year under section 469(j)(9) and the rules to be contained in § 1.469-6T (relating to the election to increase the basis of certain property by disallowed credits).

(iii) *Separately identified credits.* In identifying the credits from an activity that are disallowed under this paragraph (f)(3), the taxpayer need not account separately for any credit unless such credit may, if separately taken into account, result in an income tax liability for any taxable year different from that which would result were such credit not taken into account separately. For related rules applicable to partnerships and S corporations, see § 1.702-1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Credits that must be accounted for separately include (but are not limited to)—

(A) Credits (other than the low-income housing and rehabilitation investment credits) from a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) that arise in a taxable year in which the taxpayer actively participates (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in such activity;

(B) Credits (other than the low-income housing and rehabilitation investment credits) from a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) that arise in a taxable year in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in such activity;

(C) Low-income housing and rehabilitation investment credits from a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T); and

(D) Any credit that is subject to the limitations of sections 26(a), 28(d)(2), 29(b)(5), or 38(c) in a manner that differs from the manner in which any other credit is subject to such limitations.

(4) *Carryover of disallowed deductions and credits.* Any deduction or credit from an activity of the taxpayer that is disallowed for a taxable year under paragraph (f)(2) or (3) of this section, respectively, shall be treated for purposes of section 469 and the regulations thereunder as a deduction or credit, as the case may be, from such activity for the taxpayer's immediately succeeding taxable year. The following example illustrates the application of this pragraph (f)(4):

Example. The facts are the same as in example (1) in paragraph (f)(2)(i)(D) of this section. The $7,560 of loss from activity A and the $13,440 of loss from activity B that are disallowed for the taxable year under paragraph (f)(2) of this section are allocated among the passive activity deductions from those activities for such year under paragraph (f)(2)(ii) of this section and are treated under this paragraph (f)(4) as deductions from activities A and B, respectively, for the succeeding taxable year.

(g) *Application of these rules to C corporations*—(1) *In general.* Except as otherwise provided in the rules to be contained in paragraph (k) of this section, section 469 and the regulations thereunder do not apply to any corporation that is not a personal service corporation or a closely held corporation for the taxable year. See paragraphs (g) (4) and (5) of this section for special rules for computing the passive activity loss and passive activity credit, respectively, of a closely held corporation.

(2) *Definitions.* For purposes of section 469 and the regulations thereunder—

(i) The term "personal service corporation" means a C corporation that is a personal service corporation for the taxable year (within the meaning of § 1.441-4T(d)); and

(ii) The term "closely held corporation" means a C corporation that meets the stock ownership requirements of section 542(a)(2) (taking into account the modifications in section 465(a)(3)) for the taxable year and is not a personal service corporation for such year.

(3) *Participation of corporations*—(i) *Material participation.* For purposes of section 469 and the regulations thereunder, a corporation described in paragraph (g)(2) of this section shall be treated as materially participating in an activity for a taxable year if and only if—

(A) One or more individuals, each of whom is treated under paragraph (g)(3)(iii) of this section as materially participating in such activity for the taxable year, directly or indirectly hold (in the aggregate) more than 50 percent (by value) of the outstanding stock of such corporation; or

(B) In the case of a closely held corporation (within the meaning of paragraph (g)(2)(ii) of this section), the requirements of section 465(c)(7)(C) (without regard to clause (iv) thereof and taking into account section 465(c)(7)(D)) are met with respect to such activity.

(ii) *Significant participation.* For purposes of § 1.469-2T(f)(2), an activity of a corporation described in paragraph (g)(2) of this section shall be treated as a significant participation passive activity for a taxable year if and only if—

(A) The corporation is not treated as materially participating in such activity for the taxable year; and

(B) One or more individuals, each of whom is treated under paragraph (g)(3)(iii) of this section as significantly participating in such activity, directly or indirectly hold (in the aggregate) more than 50 percent (by value) of the outstanding stock of such corporation.

(iii) *Participation of individual.* Whether an individual is treated for purposes of this paragraph (g)(3) as materially participating or significantly participating in an activity of a corporation shall be determined under the rules of § 1.469-5T, except that in applying such rules—

(A) All activities of the corporation shall be treated as activities in which the individual holds an interest in determining whether the individual participates (within the meaning of § 1.469-5T(f)) in an activity of the corporation; and

(B) The individual's participation in all activities other than activities of the corporation shall be disregarded in determining whether the individual's participation in an activity of the corporation is treated as material participation under § 1.469-5T(a)(4) (relating to material participation in significant participation activities).

(4) *Modified computation of passive activity loss in the case of closely held corporations.*—(i) *In general.* A closely held corporation's passive activity loss for the taxable year is the amount, if any, by which the corporation's passive activity deductions for the taxable year (within the meaning of § 1.469-2T(d)) exceed the sum of—

(A) The corporation's passive activity gross income for the taxable year (within the meaning of § 1.469-2T(c)); and

(B) The corporation's net active income for the taxable year.

(ii) *Net active income.* For purposes of this paragraph (g)(4), a corporation's net active income for the taxable year is such corporation's taxable income for the taxable year, determined without regard to the following items for the year:

(A) Passive activity gross income;

(B) Passive activity deductions;

(C) Portfolio income (within the meaning of § 1.469-2T(c)(3)(i)), including any gross income that is treated as portfolio income under any other provision of the regulations (see, e.g., § 1.469-2T(c)(2)(iii)(E) (relating to gain from the disposition of substantially appreciated property formerly held for investment) and § 1.469-2T(f)(10) (relating to certain recharacterized passive activity gross income);

(D) Gross income that is treated under § 1.469-2T(c)(6) (relating to gross income from certain oil or gas properties) as not from a passive activity;

(E) Gross income and deductions from any trade or business activity (within the meaning of paragraph (e)(2) of this section) that is described in paragraph (e)(6) of this section (relating to certain activities of trading personal property) but only if the corporation did not materially participate in such activity for the taxable year;

(F) Deductions described in § 1.469-2T(d)(2)(i), (ii), and (iv) (relating to certain deductions attributable to portfolio income); and

(G) Interest expense allocated under § 1.163-8T to a portfolio expenditure (within the meaning of § 1.163-8T(b)(6)).

(iii) *Examples.* The following examples illustrate the application of this paragraph (g)(4):

Example (1). (i) For 1987, X, a closely held corporation, is engaged in two activities, a trade or business activity in which X materially participates for 1987 and a rental activity. X also holds portfolio investments. For 1987, X has the following gross income and deductions:

Gross income:	
Rents	$60,000
Gross income from business	100,000
Portfolio income	35,000
Total	$195,000
Deductions:	
Rental deductions	($100,000)
Business deductions (80,000)	
Interest expense allocable to portfolio expenditures under § 1.163-8T	(10,000)
Deductions (other than interest expense) clearly and directly allocable to portfolio income	(5,000)
Total	($195,000)

(ii) The corporation's net active income for 1987 is $20,000, computed as follows:

Gross income		$195,000	
Amounts not taken into account in computing net active income:			
Rents (see paragraph (g)(4)(ii)(A) of this section)	$60,000		
Portfolio income (see paragraph (g)(4)(ii)(C) of this section)	$35,000		
	$95,000	($95,000)	
Gross income taken into account in computing net active income		$100,000	$100,000
Deductions		($195,000)	
Amounts not taken into account in computing net active income:			
Rental deductions (see paragraph (g)(4)(ii)(B) of this section)	($100,000)		
Interest expense allocated to portfolio expenditures (see paragraph (g)(4)(ii)(G) of this section)	($10,000)		
Other deductions clearly and directly allocable to portfolio income (see paragraph (g)(4)(ii)(F) of this section)	($5,000)		
	($115,000)	$115,000	
Deductions taken into account in computing net active income		($80,000)	($80,000)
Net active income			$20,000

(iii) Under paragraph(g)(4)(i) of this section, X's passive activity loss for 1987 is $20,000, the amount by which the passive activity deductions for the taxable year ($100,000) exceed the sum of (a) the passive activity gross income for the taxable year ($60,000) and (b) the net active income for the taxable year ($20,000). Under paragraph (f)(4) of this section, the $20,000 of deductions from X's rental activity that are disallowed for 1987 are treated as deductions from the rental activity for 1988. If computed without regard to the net active income for the taxable year, X's passive activity loss would be $40,000 ($100,000 of rental deductions minus $60,000 of rental income). Thus, the effect of the rule in paragraph (g)(4)(i) of this section is to reduce the corporation's passive activity loss for the taxable year by the amount of the corporation's net active income for such year.

(iv) Under these facts, X's taxable income for 1987 is $20,000, computed as follows:

Gross income		$195,000
Deductions:		
Total deductions	($195,000)	
Passive activity loss	$20,000	
Allowable deductions	($175,000)	($175,000)
Taxable income		$20,000

Example (2). (i) The facts are the same as in example (1), except that, in 1988, X has a loss from the trade or business activity, and a net operating loss ("NOL") of $15,000 that is carried back under section 172(b) to 1987. Since NOL carrybacks are taken into account in computing net active income, X's net active income for 1987 must be recomputed as follows:

Net active income before NOL carryback	$20,000
NOL carryback	($15,000)
Net active income	$5,000

(ii) Under these facts, X's disallowed passive activity loss for 1987 is $35,000, the amount by which the passive activity deductions for the taxable year ($100,000) exceed the sum of (a) the passive activity gross income for the taxable year ($60,000) and (b) the net active income for the taxable year ($5,000).

(iii) Under paragraph (f)(4) of this section, the $35,000 of deductions from X's rental activity that are disallowed for 1987 are treated as deductions from the rental activity for 1988. X's taxable income for 1987 is $20,000, computed as follows:

Gross income		$195,000
Deductions:		
Total deductions	($210,000	
Passive activity loss	$35,000	
Allowable deductions	($175,000)	($175,000)
Taxable income		$20,000

Thus, taking the NOL carryback into account in computing net active income for 1987 does not affect X's taxable income for 1987, but increases the deductions treated under paragraph (f)(4) as deductions from X's rental activity for 1988 and decreases X's NOL carryover to years other than 1987.

(5) *Allowance of passive activity credit of closely held corporations to extent of net active income tax liability*—(i) *In general.* Solely for purposes of determining the amount disallowed under paragraph (a)(1)(ii) of this section, a closely held corporation's passive activity credit for the taxable year shall be reduced by such corporation's net active income tax liability for such year.

(ii) *Net active income tax liability.* For purposes of paragraph (g)(5)(i) of this section, a corporation's net active income tax liability for a taxable year is the amount (if any) by which—

(A) The corporation's regular tax liability (within the meaning of section 26(b)) for the taxable year, determined by reducing the corporation's taxable income for such year by an amount equal to the excess (if any) of the corporation's passive activity gross income for such year over the corporation's passive activity deductions for such year; exceeds

(B) The sum of—

(*1*) The corporation's regular tax liability for the taxable year, determined by reducing the corporation's taxable income for such year by an amount equal to the excess (if any) of the sum of the corporation's net active income (within the meaning of paragraph (g)(4)(ii) of this section) and passive activity gross income for such year over the corporation's passive activity deductions for such year; and

(*2*) The corporation's credits (other than credits from passive activities) that are allowable for the taxable year (without regard to the limitations contained in sections 26(a), 28(d)(2), 29(b)(5), 38(c), and 469).

(h) *Special rules for affiliated group filing consolidated return*—(1) *In general.* For purposes of computing the consolidated taxable income and tax liability of an affiliated group of corporations filing a consolidated return for the taxable year, and the separate taxable income (within the meaning of § 1.1502-12) of each member of such group, section 469 and the regulations thereunder shall be applied in the manner provided in this paragraph (h).

(2) *Definitions.* For purposes of this paragraph (h)—

(i) The terms "group," "member," "subsidiary," and "consolidated return year" shall have the meanings set forth in § 1.1502–1;

(ii) The term "consolidated group" means a group filing a consolidated return for the taxable year; and

(iii) The term "consolidated taxable income" shall have the meaning set forth in § 1.1502–11.

(3) *Disallowance of consolidated group's passive activity loss or credit.* A consolidated group's passive activity loss or passive activity credit for the taxable year shall be disallowed to the extent provided in paragraph (a) of this section. For purposes of the preceding sentence, a consolidated group's passive activity loss and passive activity credit shall be determined by taking into account the following items of each member of such group:

(i) Passive activity gross income;

(ii) Passive activity deductions;

(iii) Net active income (in the case of a consolidated group treated as a closely held corporation under paragraph (h)(4)(ii) of this section); and

(iv) Credits from passive activities.

(4) *Status and material participation of members*—(i) *Determination by reference to status and participation of group.* For purposes of section 469 and the regulations thereunder—

(A) Each member of a consolidated group shall be treated as a closely held corporation or personal service corporation, respectively, for the taxable year, if and only if the consolidated group is treated (under the rules of paragraph (h)(4)(ii) of this section) as a closely held corporation or personal service corporation for such year; and

(B) The determination of whether a trade or business activity (within the meaning of paragraph (e)(2) of this section) conducted by one or more members of a consolidated group is a passive activity of such members shall be made by reference to the consolidated group's participation in such activity.

(ii) *Determination of status and material participation of consolidated group.* For purposes of determining under paragraph (g)(2) of this section whether a consolidated group is treated as a closely held corporation or a personal service corporation, and determining under paragraph (g)(3) of this section whether the consolidated group materially participates in any activity conducted by one or more members of such group—

(A) The members of such consolidated group shall be treated as one corporation;

(B) Only the outstanding stock of the common parent shall be treated as outstanding stock of such corporation;

(C) An employee of any member of such group shall be treated as an employee of such corporation; and

(D) An activity is treated as the principal activity of such corporation if and only if it is the principal activity (within the meaning of § 1.44–4T(f)) of the consolidated group.

(5) *Modification of rules for identifying disallowed passive activity deductions and credits*—(i) *Identification of disallowed deductions.* In applying paragraphs (f) (2) and (4) of this section to a consolidated group for purposes of identifying the passive activity deductions of such consolidated group and of each member of such consolidated group that are disallowed for the taxable year and treated as deductions from activities for the succeeding taxable year, the following rules shall apply:

(A) A ratable portion (within the meaning of paragraph (h)(5)(ii) of this section) of the passive activity loss of the consolidated group that is disallowed for the taxable year shall be allocated to each member of the group;

(B) Pararaph (f)(2) of this section shall then be applied to each member of the group as if—

(1) Such member were a separate taxpayer; and

(2) The amount allocated to such member under paragraph (h)(5)(i)(A) of this section were the amount of such member's passive activity loss that is disallowed for the taxable year; and

(C) Paragraph (f)(4) of this section shall be applied to each member of the group as if it were a separate taxpayer.

(ii) *Ratable portion of disallowed passive activity loss.* For purposes of paragraph (h)(5)(i)(A) of this section, a member's ratable portion of the disallowed passive activity loss of the consolidated group is the amount of such disallowed loss multiplied by the fraction obtained by dividing—

(A) The amount of the passive activity loss of such member of the consolidated group that would be disallowed for the taxable year if the items of gross income and deduction of such member were the only items of the group for such year; by

(B) The sum of the amounts described in paragraph (h)(5)(ii)(A) of this section for all members of the group.

(iii) *Identification of disallowed credits.* In applying paragraph (f)(3) of this section to a consolidated group for purposes of identifying the credits from passive activities of members of such consolidated group that are disallowed for the taxable year, the consolidated group shall be treated as one taxpayer. Thus, a ratable portion of each of the group's credits from passive activities is disallowed.

(6) *Transactions between members of a consolidated group*—(i) *Scope.* This paragraph (h)(6) provides rules regarding the treatment, for purposes of section 469 and the regulations thereunder, of items of income and deduction attributable to intercompany transactions. See paragraph (h)(6)(iv) of this section for the definition of "intercompany transaction" and certain other terms used in this paragraph (h)(6).

(ii) *Recharacterization of gain or loss from intercompany transactions other than deferred intercompany transactions*—(A) *In general.* If the selling member in an intercompany transaction (other than a deferred intercompany transaction) recognizes an item of gain or loss described in § 1.1502–13(b) that is directly related to an item of deduction of the purchasing member, and both the gain or loss and the directly related item of deduction are taken into account in computing consolidated taxable income for the same taxable year, the items of income or deduction that are taken into account by the selling member in computing such gain or loss shall be taken into account in computing consolidated taxable income for such taxable year as items of income or deduction of the selling member from the activity to which the directly related deduction of the purchasing member is attributable.

(B) *Recharacterization of gain or loss as portfolio items.* Any item of income or deduction of a selling member that is recharacterized under this paragraph (h)(6)(ii) shall be treated as an item of income or deduction described in § 1.469–2T(c)(3)(i) (relating to portfolio income) or § 1.469–2T(d)(2)(i) (relating to expenses clearly and directly allocable to portfolio income), as the case may be, if and only if the directly related item of deduction is a deduction described in § 1.469-2T (d)(2)(i) or a deduction for interest expense that is allocated under § 1.163-8T to a portfolio expenditure (within the meaning of § 1.163-8T (b)(6)).

(iii) *Deferred intercompany transactions*—(A) *In general.* For purposes of section 469 and the regulations thereunder, the treatment of deferred gain or loss on a deferred intercompany transaction between members of a group shall be determined in accordance with this paragraph (h)(6)(iii).

(B) *Deferred intercompany transactions involving property subject to depreciation, amortization, or depletion.* If, for any consolidated return year, the selling member in a deferred intercompany transaction is required to take into account deferred gain or loss under § 1.1502-13(d) as a result of depreciation, amortization, or depletion of a member of the group, then for purposes of section 469 and the regulations thereunder such deferred gain or loss shall be taken into account for such year as gain or loss of the selling member from the activity (or activities) to which such depreciation, amortization, or depletion deductions are attributable.

(C) *Restoration of deferred gain or loss on dispositions.* If, for any consolidated return year, the selling member in a deferred intercompany transaction (other than a deferred intercomapny transaction described in § 1.1502-13(e)(1)) is required to take deferred gain or loss into account under § 1.1502-13(e)(2) or (f), then for purposes of section 469 and the regulations thereunder—

(*1*) Such deferred gain or loss shall be treated as gain or loss of the selling member from a disposition of the property involved in such deferred intercompany transaction at the time of (*i*) the event that requires such gain or loss to be taken into account or (*ii*) in the case of a transaction described in § 1.1502-13(e)(2), the disposition of such property outside the consolidated group; and

(*2*) Such deferred gain or loss shall, except as otherwise provided in § 1.1502-2T (c)(2) or (d)(5), be taken into account for such year as gain or loss of the selling member from the activity (or activities) of the affiliated group in which the property involved in such deferred intercompany transaction is used immediately preceding the time specified in paragraph (h)(6)(iii)(C)(*1*) of this section.

See paragraph (h)(8) of this section, relating to dispositions by a member of substantially appreciated property formerly used in a nonpassive activity.

(D) *Certain recharacterized items treated as portfolio items.* Any deferred gain or loss or a selling member that is recharacterized under this paragraph (h)(6)(iii) shall be treated as an item of income or deduction described in § 1.469-2T(c)(3)(i) (relating to portfolio income) or § 1.469-2T(d)(2)(i) (relating to expenses clearly and directly allocable to portfolio income), as the case may be, if and only if the property involved in the transaction is property that produces portfolio income (within the meaning of § 1.469-2T(c)(3)((i)).

(E) *Property involved in deferred intercompany transaction.* For purposes of this paragraph (h)(6)(iii), the property involved in a deferred intercompany transaction is the property sold or exchanged in such transaction or the property with respect to which expenditures incurred in such transaction are capitalized.

(iv) *Definitions.* For purposes of this paragraph (h)(6), the terms set forth below shall have the following meanings:

(A) *Deferred intercompany transaction.* The term "deferred intercompany transaction" shall have the meaning set forth in § 1.1502-13(a)(2).

(B) *Directly related.* An item of gross income and an item of deduction are "directly related" if and to the extent that the same amount paid or accrued generates both the income and the deduction, without regard to whether the income and the deduction are taken into account by the taxpayer in the same taxable year.

(C) *Intercompany transaction.* The term "intercompany transaction" shall have the meaning set forth in § 1.1502-13(a)(1).

(D) *Purchasing member.* The term "purchasing member" shall have the meaning set forth in § 1.1502-13(a).

(E) *Selling member.* The term "selling member" shall have the meaning set forth in § 1.502-13(a).

(7) *Disposition of stock of a member of an affiliated group.* Any gain recognized by a member on the disposition of stock of a subsidiary (including income resulting from the recognition of an excess loss account under § 1.1502-19 (a)) shall be treated as portfolio income (within the meaning of § 1.469-2T (c)(3)(i)).

(8) *Dispositions of property used in multiple activities.* The determination of whether § 1.469-2T(c)(2)(ii) or (iii) or (d)(5)(ii) applies to a disposition (including a deemed disposition described in paragraph (h)(6)(iii)(C)(*1*) of this section) of property by a member of a consolidated group shall be made by treating such member as having held the property for the entire period that the group has owned such property and as having used the property in all of the activities in which the group has used such property

(i) [Reserved]

(j) *Spouses filing joint return*—(1) *In general.* Except as otherwise provided in the regulations under section 469, spouses filing a joint return for a taxable year shall be treated for such year as one taxpayer for purposes of section 469 and the regulations thereunder Thus, for example, spouses filing a joint return are treated as one taxpayer for purposes of—

(i) Section 1.469-2T (relating generally to the computation of such taxpayer's passive activity loss); and

(ii) Paragraph (f) of this section (relating to the allocation of such taxpayer's disallowed passive activity loss and passive activity credit among activities and the identification of disallowed passive activity deductions and credits from passive activities).

(2) *Exceptions to treatment as one taxpayer*—(i) *Identification of disallowed deductions and credits.* For purposes of paragraphs (f)(2)(iii) and (3) (iii) of this section, spouses filing a joint return for the taxable year must account separately for the deductions and credits attributable to the interests of each spouse in any activity.

(ii) *Treatment of deductions disallowed under sections 704(d), 1366(d), and 465.* Notwithstanding any other provision of this section or § 1.469-2T, this paragraph (j) shall not affect the application of section 704(d), section 1366(d), or section 465 to taxpayers filing a joint return for the taxable year.

(iii) *Treatment of losses from working interests.* Paragraph (e)(4) of this section (relating to losses and credits from certain interests in oil and gas wells) shall be applied by treating a husband and wife (whether or not filing a joint return) as separate taxpayers.

(3) *Joint return no longer filed.* If an individual—

(A) Does not file a joint return for the taxable years; and

(B) Filed a joint return for the immediately preceding taxable year;

then the passive activity deductions and credits allocable to such individual's activities for the taxable year under paragraph (f)(4) of this section shall be determined by taking into account the items of deduction and credit attributable to such individual's interests in passive activities for the immediately preceding taxable year. See paragraph (j)(2)(i) of this section.

(4) *Participation of spouses.* Rules treating an individual's participation in an activity as participation of such individual's spouse in such activity (without regard to whether the spouses file a joint return) are contained in § 1.469-5T(f)(3).

(k) *Former passive activities and changes in status of corporations.* [Reserved]

§ 1.469-2T Passive activity loss (temporary).

(a) *Scope of this section.* This section contains rules for determining the amount of the taxpayer's passive activity loss for the taxable year for purposes of section 469 and the regulations thereunder. The rules contained in this section—

(1) Provide general guidance for identifying items of income and deduction that are taken into account in determining the amount of the passive activity loss for the taxable year;

(2) Specify particular items of income and deduction that are not taken into account in determining the amount of the passive activity loss for the taxable year; and

(3) Specify the manner in which provisions of the Internal Revenue Code and the regulations, other than section 469 and the regulations thereunder, are applied for purposes of determining the extent to which items of deduction are taken into account for a taxable year in computing the amount of the passive activity loss for such year.

(b) *Definition of passive activity loss*—(1) *In general.* In the case of a taxpayer other than a closely held corporation (within the meaning of § 1.469-1T(g)(2)(ii)), the passive activity loss for the taxable year is the amount, if any, by which the passive activity deductions for the taxable year exceed the passive activity gross income for the taxable year.

(2) *Cross references.* See paragraph (c) of this section for the definition of "passive activity gross income," paragraph (d) of this section for the definition of "passive activity deduction," and § 1.469-1T(g)(4) for the computation of the passive activity loss of a closely held corporation.

(c) *Passive activity gross income*—(1) *In general.* Except as otherwise provided in the regulations under section 469, passive activity gross income for a taxable year includes an item of gross income if and only if such income is from a passive activity.

(2) *Treatment of gain from disposition of an interest in an activity or an interest in property used in an activity*—(i) *In general*—(A) *Treatment of gain.* Except as otherwise provided in the regulations under section 469, any gain recognized upon the sale, exchange or other disposition (a "disposition") of an interest in property used in an activity at the time of the disposition or of an interest in an activity held through a partnership or S corporation is treated in the following manner:

(*1*) The gain is treated as gross income from such activity for the taxable year or years in which it is recognized;

(*2*) If the activity is a passive activity of the taxpayer for the taxable year of the disposition, the gain is treated as passive activity gross income for the taxable year or years in which it is recognized; and

(*3*) If the activity is not a passive activity of the taxpayer for the taxable year of the disposition, the gain is treated as not from a passive activity.

(B) *Dispositions of partnership interests and S corporation stock.* A partnership interest or S corporation stock is not property used in an activity for purposes of this paragraph (c)(2). See paragraph (e)(3) of this section for rules treating the gain recognized upon the disposition of a partnership interest or S corporation stock as gain from the disposition of interests in the activities in which the partnership or S corporation has an interest.

(C) *Interest in property.* For purposes of applying this paragraph (c)(2) to a disposition of property—

(*1*) Any material portion of the property that was used, at any time before the disposition, in any activity at a time when the remainder of the property was not used in such activity shall be treated as a separate interest in property; and

(*2*) The amount realized from the disposition and the adjusted basis of the property must be allocated among the separate interests in a reasonable manner.

(D) *Examples.* The following examples illustrate the application of this paragraph (c)(2)(i):

Example (1). A owns an interest in a trade or business activity in which A has never materially partcipated. In 1987, A sells equipment that was used exclusively in the activity and realizes a gain on the sale. Under paragraph (c)(2)(i)(A)(*2*) of this section, the gain is passive activity gross income.

Example (2). B owns an interest in a trade or business activity in which B materially participates for 1987. In 1987, B sells a building used in the activity in an installment sale and realizes a gain on the sale. B does not materially participate in the activity for 1988 or any subsequent year. Under paragraph (c)(2)(i)(A)(*3*) of this section, none of B's gain from the sale (including gain taken into account after 1987) is passive activity gross income.

Example (3). C enters into a contract to acquire property used by the seller in a rental activity. Before acquiring the property pursuant to the contract, C sells all rights under the contract and realizes a gain on the sale. Since C's rights under the contract are not property used in a rental activity, the gain is not income from a rental activity. The result would be the same if C owned an option to acquire the property and sold the option.

Example (4). D sells a ten-floor office building. D owned the building for three years preceding the sale and at all times during that period used seven floors of the building in a trade or business activity and three floors in a rental activity. The fair market value per square foot is substantially the same throughout the building, and D did not maintain a separate adjusted basis for any part of the building. Under paragraph (c)(2)(i)(C)(*1*) of this section, the seven floors used in the trade or business activity and the three floors used in the rental activity are treated as separate interests in property. Under paragraph (c)(2)(i)(C)(*2*) of this section, the amount realized and the adjusted basis of the building must be allocated between the separate interests in a reasonable manner. Under these facts, an allocation based on the square footage of the parts of the building used in each activity would be reasonable.

Example (5). The facts are the same as in example (4), except that two of the seven floors used in the trade or business activity were used in the rental activity until five months before the sale. Under paragraph (c)(2)(i)(C)(*1*) of this section, the five floors used exclusively in the trade or business activity and the two floors used first in the rental activity and then in the trade or business activity are treated as separate interests in property. See paragraph (c)(2)(ii) of this section for rules for allocating amount realized and adjusted basis upon a disposition of an interest in property used in more than one activity during the 12-month period ending on the date of the disposition.

(ii) *Disposition of property used in more than one activity in 12-month period preceding disposition.* In the case of a disposition of an interest in property that is used in more than one activity during the 12-month period ending on the date of the disposition, the amount realized from the disposition and the adjusted basis of such interest must be allocated among such activities on a basis that reasonably reflects the use of such interest in property during such 12-month period. For purposes of this paragraph (c)(2)(ii), an allocation of the amount realized and adjusted basis solely to the activity in which an iterest in property is predominantly used during the 12-month period ending on the date of the disposition reasonably reflects the use of such interest in property if the fair market value of such interest does not exceed the lesser of—

(A) $10,000; and

(B) 10 percent of the sum of the fair market value of such interest and the fair market value of all other property used in such activity immediately before the disposition.

The following examples illustrate the application of this paragraph (c)(2)(ii):

Example (1). The facts are the same as in example (5) of paragraph (c)(2)(i)(D) of this section. Under paragraph (c)(2)(i)(C)(*2*) of this section, D allocates the amount realized and adjusted basis of the building 30 percent to the three floors used exclusively in the rental activity, 50 percent to the five floors used exclusively in the trade or business activity, and 20 percent to the two floors used first in the rental activity and then in the trade or business activity. Under this paragraph (c)(2)(ii), the amount realized and adjusted basis allocated to the two floors that were used in both activities during the 12-month period ending on the date of the disposition must also be allocated between such activities. Under these facts, an allocation of 7/12 of such amounts to the rental activity and 5/12 of such amounts to the trade or business activity would reasonably reflect the use of the two floors during the 12-month period ending on the date of the disposition.

Example (2). B is a limited partner in a partnership that sells a tractor-trailer. During the 12-month period ending on the date of the sale, the tractor-trailer was used in several activities, and the partnership allocates the amount realized from the disposition and the adjusted basis of the tractor-trailer among the activities based on the number of days during the 12-month period that the partnership used the tractor-trailer in each activity. Under these facts, the partnership's allocation reasonably reflects the use of the tractor-trailer during the 12-month period ending on the date of the sale.

Example (3). C sells a personal computer for $8,000. During the 12-month period ending on the date of the sale, 70 percent of C's use of the computer was in a passive activity. Immediately before the sale, the fair market value of all property used in the passive activity (including the personal computer) was $200,000. Under these facts, the computer was predominatly used in the passive activity during the 12-month period ending on the date of the sale, and the value of the computer, as measured by its sale price ($8,000), does not exceed the lesser of (a) $10,000, and (b) 10 percent of the value of all property used in the activity immediately before the sale ($20,000). C allocates the amount realized and the adjusted basis solely to the passive activity. Under this paragraph (c)(2)(ii), C's allocation reasonably reflects the use of the computer during the 12-month period ending on the date of the sale.

(iii) *Disposition of substantially appreciated property formerly used in nonpassive activity*—(A) *In general.* If an interest in property used in an activity is substantially appreciated at the time of its disposition, any gain from the disposition shall be treated as not from a passive activity unless such interest in property was used in a passive activity for either—

(*1*) 20 percent of the period during which the taxpayer held such interest in property; or

(*2*) The entire 24-month period ending on the date of the disposition.

(B) *Date of disposition.* For purposes of this paragraph (c)(2)(iii), a disposition of an interest in property shall be deemed to occur on the date that such interest in property becomes subject to an oral or written agreement that either requires the owner or gives the owner an option to transfer such interest in property for consideration that is fixed or otherwise determinable on such date.

(C) *Substantially appreciated property.* For purposes of this paragraph (c)(2)(iii), an interest in property is substantially appreciated if the fair market value of such interest in property exceeds 120 percent of the adjusted basis of such interest.

(D) *Coordination with paragraph (c)(2)(ii) of this section.* If paragraph (c)(2)(ii) of this section applies to the disposition of an interest in property, this paragraph (c)(2)(iii) shall apply only to that portion of the gain from the disposition of such interest in property that is characterized as gain from a passive activity after the application of paragraph (c)(2)(ii) of this section.

(E) *Coordination with section 163(d).* Gain that is treated as not from a passive activity under this paragraph (c)(2)(iii) shall be treated as income described in section 469(e)(1)(A) and paragraph (c)(3)(i) of this section if and only if such gain is from the disposition of an interest in property that was held for investment for more than 50 percent of the period during which the taxpayer held such interest in property in activities other than passive activities.

(F) *Example.* The following example illustrates the application of this paragraph (c)(2)(iii):

Example. A acquires a building on January 1, 1987, and uses the building in a trade or business activity in which A materially participates until March 31, 1997. On April 1, 1998, A leases the building to B. On December 31, 1999, A sells the building. Assuming A's lease of the building to B constitutes a rental activity (within the meaning of § 1.469–1T(e)(3)), the building is used in a passive activity for 21 months (April 1, 1998, through December 31, 1999). Thus, the building was not used in a passive activity for the entire 24-month period ending on the date of the sale. In addition, the 21-month period during which the building was used in a passive activity is less than 20 percent of A's holding period for the property (13 years). Therefore, the gain from the sale is treated under this paragraph (c)(2)(iii) as not from a pasive activity.

(3) *Items of portfolio income specifically excluded*—(i) *In general.* Passive activity gross income does not include portfolio income. For purposes of the preceding sentence, portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business (within the meaning of paragraph (c)(3)(ii) of this section), that is attributable to—

(A) Interest (including amounts treated as interest under paragraph (e)(2)(ii) of this section, relating to certain payments to partners for the use of capital); annuities; royalties (including fees and other payments for the use of intangible property); dividends on C corporation stock; and income (including dividends) from a real estate investment trust (within the meaning of section 856), regulated investment company (within the meaning of section 851), real estate mortgage investment conduit (within the meaning of section 860D), common trust fund (within the meaning of section 584), controlled foreign corporation (within the meaning of section 957), qualified electing fund (within the meaning of section 1295(a)), or cooperative (within the meaning of section 1381(a));

(B) Dividends on S corporation stock (within the meaning of section 1368(c)(2);

(C) The disposition of property that produces income of a type described in paragraph (c)(3)(i)(A) of this section; and

(D) The disposition of property held for investment (within the meaning of section 163 (d)).

(ii) *Gross income derived in the ordinary course of a trade or business.* Solely for purposes of paragraph (c)(3)(i) of this section, gross income derived in the ordinary course of a trade or business includes only—

(A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;

(B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;

(C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;

(D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);

(E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);

(F) Amount included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and

(G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

(iii) *Special rules*—(A) *Income from property held for investment by dealer.* For purposes of paragraph (c)(3)(i) of this section, a dealer's income or gain from an item of property is not dervied by the dealer in the ordinary course of a trade or business of dealing in such property if the dealer held the property for investment at any time before such income or gain is recognized.

(B) *Royalties derived in the ordinary course of the trade or business of licensing intangible property*—(*1*) *In general.* Royalties received by any person with respect to a license or other transfer of any rights in intangible property shall be considered to be derived in the ordinary course of the trade or business of licensing such property only if such person—

(*i*) Created such property; or

(*ii*) Performed substantial services or incurred substantial costs with respect to the development or marketing of such property.

(*2*) *Substantial services or costs*—(*i*) *In general.* Except as provided in paragraph (c)(3)(iii)(B)(*2*)(*ii*) of this section, the determination of whether a person has performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property shall be made on the basis of all the facts and circumstances.

(*ii*) *Exception.* A person has performed substantial services or incurred substantial costs for a taxable year with respect to the development or marketing of an item of intangible property if—

(*a*) The expenditures reasonably incurred by such person in such taxable year with respect to the development or marketing of the property exceed 50 percent of the gross royalties from licensing such property that are includible in such person's gross income for the taxable year; or

(*b*) The expenditures reasonably incurred by such person in such taxable year and all prior taxable years with respect to the development or marketing of the property exceed 25 percent of the aggregate capital expenditures (without any adjustment of amortization) made by such person with respect to the property in all such taxable years.

(*iii*) *Expenditures taken into account.* For purposes of paragraph (c)(3)(iii)(B)(*2*)(*ii*) of this section, expenditures in a taxable year include amounts chargeable to capital account for such year without regard to the year or years (if any) in which any deduction for such expenditure is allowed.

(*3*) *Passthrough entities.* For purposes of this paragraph (c)(3)(iii)(B), in the case of any intangible property held by a partnership, S corporation, estate, or trust, the determination of whether royalties from such property are derived in the ordinary course of a trade or business shall be made by applying the rules of this paragraph (c)(3)(iii)(B) to such entity and not to any holder of an interest in such entity.

(*4*) *Cross reference.* For special rules applicable to certain gross income from a trade or business of licensing intangible property, see paragraph (f)(7) of this section.

(C) *Mineral production payments.* For purposes of section 469 and the regulations thereunder—

(*1*) If a mineral production payment is treated as a loan under section 636, the portion of any payment in discharge of the production payment that is the equivalent of interest shall be treated as interest; and

(*2*) If a mineral production payment is not treated as a loan under section 636, payments in discharge of the production payment shall be treated as royalties.

(iv) *Examples.* The following examples illustrate the application of this paragraph (c)(3):

Example (1). A, an individual engaged in the trade or business of farming, disposes of farmland in an installment sale. A is not engaged in a trade or business of selling farmland. Therefore, A's interest income from the installment note is not gross income derived in the ordinary course of a trade or business.

Example (2). P, a partnership, operates a rental apartment building for low-income tenants in City Y. Under Y's laws relating to the operation of low-income housing, P is required to maintain a reserve fund to pay for the maintenance and repair of the building. P invests the reserve fund in short-term interest-bearing deposits. Because P's interest income from the investment of the reserve fund is not interest income described in paragraph (c)(3)(ii) of this section, such income is not treated as derived in the ordinary course of a trade or business. Accordingly, P's interest income from the deposits is portfolio income (within the meaning of paragraph (c)(3)(i) of this section).

Example (3). (i) B is a partner in a partnership that is engaged in an activity involving the conduct of a trade or business of dealing in securities. On February 1, the partnership acquires certain securities for investment (within the meaning of section 163(d)). On

February 2, before recognizing any income with respect to the securities, the partnership determines that it would be advisable to hold the securities primarily for sale to customers and subsequently sells them to customers in the ordinary course of its business.

(ii) Under paragraph (c)(3)(iii)(A) of this section, income or gain from any security (including any security acquired pursuant to an investment of working capital) held by a dealer for investment at any time before such income or gain is recognized is not treated for purposes of paragraph (c)(3)(i) of this section as derived by the dealer in the ordinary course of its trade or business of dealing in securities. Accordingly, B's distributive share of the partnership's interest, dividends, or gains from the securities acquired by the partnership for investment on February 1 is portfolio income of B, notwithstanding that such securities were held by the partnership, subsequent to February 1, primarily for sale to customers in the ordinary course of the partnership's trade or business of dealing in securities.

Example (4). C is a partner in a partnership that is engaged in an activity of trading or dealing in royalty interests in mineral properties. The partnership derives royalty income from royalty interests held in the activity. If the activity is a trade or business activity, C's distributive share of the partnership's royalty income from such royalty interests is treated under paragraph (c)(3)(ii)(D) of this section as derived in the ordinary course of the partnership's trade or business.

Example (5). (i) D, a calendar year individual, is a partner in a calendar year partnership that is engaged in an activity of developing and marketing a design for a system that reduces air pollution in office buildings. D has a 10 percent distributive share of all items of partnership income, gain, loss, deduction, and credit. In 1987, the partnership acquired the rights to the design for $100,000. In 1987, 1988, and 1989, the partnership incurs expenditures with respect to the development and marketing of the design, and derives gross royalties from licensing the design, in the amounts set forth in the table below. The expenditures incurred in 1987 and 1988 are currently deductible expenses. The expenditures incurred in 1989 are capitalized and may be deducted only in subsequent taxable years.

Year	Gross royalties	Expenditures	Cumulative capital expenditures
1987	$20,000	$8,000	$100,000
1988	20,000	12,000	100,000
1989	60,000	15,000	115,000
1990	120,000	0	115,000

(ii) Under paragraph (c)(3)(iii)(B)(*3*) of this section, the determination of whether royalties from intangible property are derived in the ordinary course of a trade or business of a partnership is made by applying the rules of paragraph (c)(3)(iii)(B) of this section to the partnership rather than the partners. The expenditures reasonably incurred by the partnership in 1987 with respect to the development or marketing of the design ($8,000) do not exceed 50 percent of the partnership's gross royalties for such year from licensing the design ($20,000). In addition, the sum of such expenditures incurred in 1987 and all prior taxable years ($8,000) does not exceed 25 percent of the aggregate capital expenditures made by the partnership in all such taxable years with respect to the design ($100,000). Accordingly, for 1987, the partnership is not treated under paragraph (c)(3)(iii)(B)(*2*)(*ii*) of this section as performing substantial services or incurring substantial costs with respect to the development or marketing of the design. Therefore, unless all of the facts and circumstances indicate that the partnership performed substantial services or incurred substantial costs with respect to the development or marketing of the design, D's distributive share of the partnership's royalty income for 1987 is portfolio income.

(iii) As of the end of 1988, the sum of the expenditures reasonably incurred by the partnership during such taxable year and all prior taxable years with respect to the development or marketing of the design ($20,000) does not exceed 25 percent of the aggregate capital expenditures made by the partnership in all such years with respect to the design ($100,000). However, the amount of such expenditures incurred by the partnership in 1988 ($12,000) exceeds 50 percent of the partnership's gross royalties for such year from licensing the design ($20,000). Accordingly, for 1988, under paragraph (c)(3)(iii)(B)(*2*)(*ii*)(*a*) of this section, the partnership is treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design, and D's distributive share of the partnership's royalty income for 1988 is considered for purposes of paragraph (c)(3)(i) of this section to be derived in the ordinary course of a trade or business and therefore is not portfolio income.

(iv) The expenditures reasonably incurred by the partnership in 1989 with respect to the development or marketing of the design ($15,000) do not exceed 50 percent of the partnership's gross royalties for such year from licensing the design ($60,000). However, the sum of such expenditures incurred by the partnership in 1989 and all prior taxable years ($35,000) exceeds 25 percent of the partnership's aggregate capital expenditures made in all such years with respect to the design ($115,000). Accordingly, for 1989, under paragraph (c)(3)(iii)(B)(*2*)(*ii*)(*b*) of this section, the partnership is treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design, and D's distributive share of the partnership's royalty income in 1989 is considered for purposes of paragraph (c)(3)(i) of this section to be derived in the ordinary course of a trade or business and therefore is not portfolio income.

(v) The result for 1990 is the same as for 1989, notwithstanding that the partnership incurs no expenditures in 1990 with respect to the development or marketing of the design.

Example (6). The facts are the same as in example (5), except that, for 1987, D's distributive share of the partnership's development and marketing costs is 15 percent, while D's distributive share of the partnership's gross royalties is 10 percent. Although D's distributive share of the expenditures reasonably incurred by the partnership during 1987 with respect to the development and marketing of the design ($1,200) is more than 50 percent of D's distributive share of the partnership's gross royalties from licensing the design ($2,000), D is not treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design for 1987 under paragraph (c)(3)(iii)(B)(*2*)(*ii*)(*a*) of this section. This is because, under paragraph (c)(3)(iii)(B)(*3*) of this section, the determination of whether the royalties are derived in the ordinary course of a trade or business is made by applying paragraph (c)(3)(iii)(B) of this section to the partnership, and not to D.

(4) *Items of personal service income specifically excluded*—(i) *In general.* Passive activity gross income does not include compensation paid to or on behalf of an individual for personal services performed or to be performed by such individual at any time. For purposes of this paragraph (c)(4), compensation for personal services includes only—

(A) Earned income (within the meaning of section 911(d)(2)(A)), including gross income from a payment described in paragraph (e)(2) of this section that represents compensation for the performance of services by a partner;

(B) Amounts includible in gross income under section 83;

(C) Amounts includible in gross income under sections 402 and 403;

(D) Amounts (other than amounts described in paragraph (c)(4)(i)(C) of this section) paid pursuant to retirement, pension, and other arrangements for deferred compensation for services;

(E) Social security benefits (within the meaning of section 86(d)) includible in gross income under section 86; and

(F) Other income identified by the Commissioner as income derived by the taxpayer from personal services; provided, however, that no portion of a partner's distributive share of partnership income (within the meaning of section 704(b)) or a shareholder's pro rata share of income from an S corporation (within the meaning of section 1377(a)) shall be treated as compensation for personal services.

(ii) *Example.* The following example illustrates the application of this paragraph (c)(4):

Example. C owns 50 percent of the stock of X, an S corporation. X owns rental real estate, which it manages. X pays C a salary for services performed by C on behalf of X in connection with the management of X's rental properties.

Under this paragraph (c)(4), although C's pro rata share of X's gross rental income is passive activity gross income (even if the salary paid to C is less than the fair market value of C's services), the salary paid to C does not constitute passive activity gross income.

(5) *Income from section 481 adjustment*—(i) *In general.* If a change in accounting method results in a positive section 481 adjustment with respect to an activity, a ratable portion (within the meaning of paragraph (c)(5)(iii) of this section) of the amount taken into account for a taxable year as a net positive section 481 adjustment by reason of such change shall be treated as gross income from the activity for such taxable year, and such gross income shall be treated as passive activity gross income if and only if such activity is a passive activity for the year of the change (within the meaning of section 481(a)).

(ii) *Positive section 481 adjustments.* For purposes of applying this paragraph (c)(5)—

(A) The term "net positive section 481 adjustment" means the increase (if any) in taxable income taken into account under section 481(a) to prevent amounts from being duplicated or omitted by reason of a change in accounting method; and

(B) The term "positive section 481 adjustment with respect to an activity" means the increase (if any) in taxable income that would be taken into account under section 481(a) to prevent only the duplication or omission of amounts from such activity by reason of the change in accounting method.

(iii) *Ratable portion.* The ratable portion of the amount taken into account as a net positive section 481 adjustment for a taxable year by reason of a change in accounting method is determined with respect to an activity by multiplying such amount by the fraction obtained by dividing—

(A) The positive section 481 adjustment with respect to the activity; by

(B) The sum of the positive section 481 adjustments with respect to all of the activities of the taxpayer.

(6) *Gross income from certain oil or gas properties*—(i) *In general.* Notwithstanding any other provision of the regulations under section 469, passive activity gross income for any taxable year does not include an amount of the taxpayer's gross income for such year from—

(A) An oil or gas property, if any loss from a working interest in such property for any prior taxable year beginning after December 31, 1986, was treated by the taxpayer, solely by reason of § 1.469-1T(e)(4) (relating to a special rule for losses from oil and gas working interests), and not by reason of the taxpayer's material participation in the activity, as a loss that is not from a passive activity; or

(B) Any property the basis of which is determined in whole or in part by reference to the basis of property described in paragraph(c)(6)(i)(A) of this section;

equal to the taxpayer's net income from such property for the taxable year. The preceding sentence applies without regard to whether the taxpayer's interest in the property is held through an entity that limits the taxpayer's liability (within the meaning of § 1.469-1T(e)(4)(v)).

(ii) *Net income from the property.* For purposes of this paragraph (c)(6), the taxpayer's net income for the taxable year from any property described in paragraph (c)(6)(i) of this section is the amount, if any, by which the taxpayer's gross income from such property exceeds the taxpayer's deductions for such taxable year (including any deduction treated as a deduction for such year under § 1.469-1T(f)(4)) that are reasonable allocable to such property.

(iii) *Property.* For purposes of paragraph (c)(6)(i)(A) of this section, the term "property" does not have the meaning given such term by section 614(a) or the regulations thereunder, but means any property the value of which is directly enhanced by any drilling, logging, seismic testing, or other activities any part of the costs of which were borne by the taxpayer as a result of holding the working interest described in such paragraph (c)(6)(i)(A).

(iv) *Examples.* The following examples illustrate the application of this (c)(6):

Example (1). A is a general partner in partnership P and a limited partner in partnership R. P and R own oil and gas working interests in two separate tracts of land acquired from two separate landowners. In 1987, P drills a well on its tract, and A's distributive share of P's losses from drilling the well are treated under § 1.469-1T(e)(4) as not from a passive activity. In the course of selecting the drilling site and drilling the well, P develops information indicating that the reservoir in which the well was drilled underlies R's tract as well as P's. Under these facts, P's and R's tracts are treated as one property for purposes of this paragraph (c)(6), even if A's interests in the mineral deposits in the tracts are treated as separate properties under section 614(a). Accordingly, in 1988 and subsequent years, A's distributive share of both P's and R's income and expenses from their respective tracts is taken into account in computing A's net income from the property for purposes of this paragraph (c)(6).

Example (2). B is a general partner in partnership S. S owns an oil and gas working interest in a single tract of land. In 1987, S drills a well, and B's distributive share of S's losses from drilling the well is treated under § 1.469-1T(e)(4) as not from a passive activity. In the course of drilling the well, S discovers two oil-bearing formations, one underlying the other. On December 1, 1987, S completes the well in the underlying formation. On January 1, 1988, B converts B's entire general partnership interest in S into a limited partnership interest. In 1988, S completes in, and commences production from, the shallow formation. Under these facts, the two mineral deposits in S's tract are treated as one property for purposes of this paragraph (c)(6), even if they are treated as separate properties under section, 614 (a). Accordingly, B's distributive share of S's income and expenses from both the underlying formation and from recompletion in and production from the shallow formation is taken into account in computing B's net income from the property for purposes of this paragraph (c)(6).

Example (3). C is a general partner in partnership T and a limited partner in partnership U. T and U both own oil and gas working interests in tracts of land in County X. In 1987, T drills a well, and C's distributive share of T's losses from drilling the well is treated under § 1.469-1T(e)(4) as not from a passive activity. In the course of selecting the drilling site and drilling the well, T develops information indicating a significant probability that substantial oil and gas reserves underlie most portions of County X. As a result, the value of all oil and gas properties in County X is enhanced. The information developed by T does not, however, indicate that the reservoir in which T's well is drilled underlies U's tract. Under these facts, T's and U's tracts are not treated as one property for purposes of this paragraph (c)(6), because the value of U's tract is not directly enhanced by T's activities.

(7) *Other items specifically excluded.* Notwithstanding any other provision of the regulations under section 469, passive activity gross income does not include the following:

(i) Gross income of an individual from intangible property, such as a patent, copyright, or literary, musical, or artistic composition, if the taxpayer's personal efforts significantly contributed to the creation of such property;

(ii) Gross income from a qualified low-income housing project (within the meaning of section 502 of the Tax Reform Act of 1986) for any taxable year in the relief period (within the meaning of section 502(b) of such Act;

(iii) Gross income attributable to a refund of any state, local, or foreign income, war profits, or excess profits tax;

(iv) Gross income of an individual from a covenant by such individual not to compete; and

(v) Gross income that is treated as not from a passive activity under any provision of the regulations under section 469, including but not limited to § 1.469-1T(h)(6) (relating to income from intercompany transactions of members of an affiliated group of corporations filing a consolidated return) and paragraph (f) of this section (relating to recharacterized passive income).

(d) *Passive activity deductions*—(1) *In general.* Except as otherwise provided in section 469 and the regulations thereunder, a deduction is a passive activity deduction for a taxable year if and only if such deduction—

(i) Arises (within the meaning of paragraph (d)(8) of this section) in connection with the conduct of a activity that is a passive activity for the taxable year; or

(ii) Is treated as a deduction from an activity under § 1.469-1T(f)(4) for the taxable year.

The following example illustrates the application of this paragraph (d)(1):

Example. (i) In 1987, A, a calendar year individual, acquires a partnership interest in R, a calendar year partnership. R's only activity is a trade or business activity in which A materially participates for 1987. R incurs a loss in 1987. A's distributive share of R's 1987 loss is $1,000. However, A's basis in the partnership interest at the end of 1987 (without regard to A's distributive share of partnership loss) is $600; accordingly, section 704(d) disallows any deduction in 1987 for $400 of A's distributive share of R's loss. The remainder of A's distributive share of R's loss would be allowed as a deduction for 1987 if taxable income for all taxable years were determined without regard to sections 469 and 1211. See paragraph (d)(8) of this section.

(ii) A does not materially participate in R's activity for 1988. In 1988, R again incurs a loss, and A's distributive share of the loss is again $1,000. At the end of 1988, A's basis in the partnership interest (without regard to A's distributive share of partnership loss) is $2,000; accordingly, in 1988 section 704(d) does not limit A's deduction for either A's $1,000 distributive share of R's 1988 loss or the $400 loss carried over from 1987 under the second sentence of section 704(d). These losses would be allowed as a deduction for 1988 if taxable income for all taxable years were determined without regard to sections 469 and 1211. See paragraph (d)(8) of this section.

(iii) Under these facts, only $400 of A's distributive share of R's deductions from the activity are disallowed under section 704(d) in 1987. A's remaining deductions from the activity are treated as deductions that arise in connection with the activity for 1987 under paragraph (d)(8) of this section. Because A materially participates in the activity for 1987, the activity is not a passive activity (within the meaning of § 1.469-1T(e)(1)) of A for such year. Accordingly, the deductions that are not disallowed in 1987 are not passive activity deductions.

(iv) A does not materially participate in R's activity for 1988. Accordingly, the activity is a passive activity of A for such year. No portion of A's distributive share of R's deductions from the activity is disallowed under section 704(d) in 1988. Accordingly, A's distributive share of R's deductions for 1988 and the $400 of deductions carried over from 1987 are both treated under paragraph (d)(8) of this section as deductions that arise in 1988. Since the activity is a passive activity for 1988, such deductions are passive activity deductions.

(2) *Exceptions.* Passive activity deductions do not include—

(i) A deduction for an item of expense (other than interest) that is clearly and directly allocable (within the meaning of paragraph (d)(4) of this section) to portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(ii) A deduction allowed under section 243, 244, or 245 with respect to any dividend that is not included in passive activity gross income;

(iii) Interest expense (other than interest expense described in paragraph (d)(3) of this section);

(iv) A deduction for a loss from the disposition of property of a type that produces portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(v) A deduction that, under section 469(g) and § 1.469-6T (relating to the allowance of passive activity losses upon certain dispositions of interests in passive activities), is treated as a deduction that is not a passive activity deduction;

(vi) A deduction for any state, local, or foreign income, war profits, or excess profits tax;

(vii) A miscellaneous itemized deduction (within the meaning of section 67(b)) that is subject to disallowance in whole or in part under section 67(a) (without regard to whether any amount of such deduction is disallowed under section 67);

(viii) A deduction allowed under section 170 for a charitable contribution;

(ix) An item of loss or deduction that is carried to the taxable year under section 172(a), section 1212(a)(1)(B) (in the case of corporations), or section 1212(b) (in the case of taxpayers other than corporations); and

(x) An item of loss or deduction that would have been allowed for a taxable year beginning before January 1, 1987, but for section 704(d), 1366, or 465.

(3) *Interest expense.* Except as otherwise provided in the regulations under section 469, interest expense is taken into account as a passive activity deduction if and only if such interest expense—

(i) Is allocated under § 1.163-8T to a passive activity expenditure (within the meaning of § 1.163-8T(b)(4)); and

(ii) Is not—

(A) Qualified residence interest (within the meaning of § 1.163-10T); or

(B) Capitalized pursuant to a capitalization provision (within the meaning of § 1.163-8T(m)(7)(i)).

(4) *Clearly and directly allocable expenses.* For purposes of section 469 and the regulations thereunder, an expense (other than interest expense) is clearly and directly allocable to portfolio income (within the meaning of paragraph (c)(3)(i) of this section) if and only if such expense is incurred as a result of, or incident to, an activity in which such gross income is derived or in connection with property from which such gross income is derived. For example, general and administrative expenses and compensation paid to officers attributable to the performance of services that do not directly benefit or are not incurred by reason of a particular activity or particular property are not clearly and directly allocable to portfolio income (within the meaning of paragraph (c)(3)(i) of this section).

(5) *Treatment of loss from disposition*—(i) *In general.* Except as otherwise provided in the regulations under section 469—

(A) Any loss recognized in any year upon the sale, exchange, or other disposition (a "disposition") of an interest in property used in an activity at the time of the disposition or of an interest in an activity held through a partnership or S corporation and any deduction allowed on account of the abandonment or worthlessness of such an interest is treated as a deduction from such activity; and

(B) Any such deduction is a passive activity deduction if and only if the activity is a passive activity of the taxpayer for the taxable year of the disposition (or other event giving rise to the deduction).

(ii) *Disposition of property used in more than one activity in 12-month period preceding disposition.* In the case of a disposition of an interest in property that is used in more than one activity during the 12-month period ending on the date of the disposition, the amount realized from the disposition and the adjusted basis of such interest must be allocated among such activities in the manner described in paragraph (c)(2)(ii) of this section.

(iii) *Other applicable rules*—(A) *Interest in property.* For purposes of this paragraph (d)(5), a taxpayer's interests in property used in an activity and the amounts allocated to such interests shall be determined under paragraph (c)(2)(i)(C) of this section.

(B) *Dispositions of partnership interests and S corporation stock.* A partnership interest or S corporation stock is not property used in an activity for purposes of this paragraph (d)(5). See paragraph (e)(3) of this section for rules treating the loss recognized upon the disposition of a partnership interest or S corporation stock as loss from the disposition of interests in the activities in which the partnership or S corporation has an interest.

(6) *Coordination with other limitations on deductions that apply before section 469*—(i) *In general.* An item of deduction from a passive activity that is disallowed for a taxable year under section 704(d), 1366(d), or 465 is not a passive activity deduction for the taxable year. Paragraphs (d)(6) (ii) and (iii) of this section provide rules for determining the extent to which items of deduction from a passive activity are disallowed for a taxable year under sections 704(d), 1366(d), and 465.

(ii) *Proration of deductions disallowed under basis limitations*—(A) *Deductions disallowed under section 704(d).* If any amount of a partner's distributive share of a partnership's loss for the taxable year is disallowed under section 704(d), a ratable portion of the partner's distributive share of each item of deduction or loss of the partnership is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing—

(*1*) The amount of the partner's distributive share of partnership loss that is disallowed for the taxable year; by

(*2*) The sum of the partner's distributive shares of all items of deduction and loss of the partnership for the taxable year.

(B) *Deductions disallowed under section 1366(d).* If any amount of an S corporation shareholder's pro rata share of an S corporation's loss for the taxable year is disallowed under section 1366(d), a ratable portion of the taxpayer's pro rata share of each item of deduction or loss of the S corporation is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing—

(*1*) The amount of the shareholder's pro rata share of S corporation loss that is disallowed for the taxable year; by

(*2*) The sum of the shareholder's pro rata shares of all items of deduction and loss of the corporation for the taxable year.

(iii) *Proration of deductions disallowed under at-risk limitation.* If any amount of the taxpayer's loss from an activity (within the meaning of section 465(c)) is disallowed under section 465 for the taxable year, a ratable portion of each item of deduction or loss from the activity is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing—

(*1*) The amount of the loss from the activity that is disallowed for the taxable year; by

(*2*) The sum of all deductions from the activity for the taxable year.

(iv) *Coordination of basis and at-risk limitations.* The portion of any item of deduction or loss that is disallowed for the taxable year under section 704(d) or 1366(d) is not taken into account for the taxable year in determining the loss from an activity (within the meaning of section 465(c)) for purposes of applying section 465.

(v) *Separately identified items of deduction and loss.* In identifying the items of deduction and loss from an activity that are not disallowed under sections 704(d), 1366(d), and 465 (and that therefore may be treated as passive activity deductions), the taxpayer need not account separately for any item of deduction or loss unless such item may, if separately taken into account, result in an income tax liability different from that which would result were such item of deduction or loss taken into account separately. For related rules applicable to partnerships and S corporations, see § 1.702-1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Items of deduction or loss that must be accounted for separately include (but are not limited to) items of deduction or loss that—

(A) Are attributable to separate activities (within the meaning of the rules to be contained in § 1.469-4T);

(B) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in taxable years in which the taxpayer activity participates (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in such activity;

(C) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in taxable years in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in such activity;

(D) Arose in a taxable year beginning before 1987 and were not allowed for such taxable year under section 704(d), 1366(d), or 465(a)(2);

(E) Are taken into account under section 1211 (relating to the limitation on capital losses) or section 1231 (relating to property used in a trade or business and involuntary conversions); or

(F) Are attributable to pre-enactment interests in activities (within the meaning of § 1.469-11T(c)).

(7) *Deductions from section 481 adjustment*—(i) *In general.* If a change in accounting method results in a negative section 481 adjustment with respect to an activity, a ratable portion (within the meaning of

paragraph (d)(7)(iii) of this section) of the amount taken into account for a taxable year as a net negative section 481 adjustment by reason of such change shall be treated as a deduction from the activity for such taxable year, and such deduction shall be treated as a passive activity deduction if and only if such activity is a passive activity for the year of the change (within the meaning of section 481(a)). See the rules to be contained in § 1.469-1T(k) for the treatment of passive activity deductions from an activity in taxable years in which the activity is a former passive activity.

(ii) *Negative section 481 adjustments.* For purposes of applying this paragraph (d)(7)—

(A) The term "net negative section 481 adjustment" means the decrease (if any) in taxable income taken into account under section 481(a) to prevent amounts from being duplicated or omitted by reason of a change in accounting method; and

(B) The term "negative section 481 adjustment with respect to an activity" means the decrease (if any) in taxable income that would be taken into account under section 481(a) to prevent only the duplication or omission of amounts from such activity by reason of the change in accounting method.

(iii) *Ratable portion.* The ratable portion of the amount taken into account as a net negative section 481 adjustments for a taxable year by reason of a change in accounting method is determined with respect to an activity by multiplying such amount by the fraction obtained by dividing—

(A) The negative section 481 adjustment with respect to the activity; by

(B) The sum of the negative section 481 adjustments with respect to all of the activities of the taxpayer.

(8) *Taxable year in which item arises.* For purposes of this paragraph (d), an item of deduction arises in the taxable year in which such item would be allowable as a deduction under the taxpayer's method of accounting if taxable income for all taxable years were determined without regard to sections 469 and 1211.

(e) *Special rules for partners and S corporation shareholders*—(1) *In general.* For purposes of section 469 and the regulations thereunder, the character (as an item of passive activity gross income or passive activity deduction) of each item of gross income and deduction allocated to a taxpayer from a partnership or S corporation (a "passthrough entity") shall be determined, in any case in which participation is relevant, by reference to the participation of the taxpayer in the activity (or activities) that generated such item. Such participation is determined for the taxable year of the passthrough entity (and not the taxable year of the taxpayer). The following example illustrates the application of this paragraph (e)(1):

Example. A, a calendar year individual, is a partner in a partnership that has a taxable year ending January 31. During its taxable year ending on January 31, 1988, the partnership engages in a single trade or business activity. For the period from February 1, 1987, through January 31, 1988, A does not materially participate in this activity. In A's calendar year 1988 return, A's distributive share of the partnership's gross income and deductions from the activity must be treated as passive activity gross income and passive activity deductions, without regard to A's participation in the activity from February 1, 1988, through December 31, 1988. See also § 1.469-11T(a)(4) (relating to the effective date of, and transition rules under, section 469 and the regulations thereunder).

(2) *Payments under sections 707(a), 707(c), and 736(b).* Items of gross income and deduction attributable to a transaction described in section 707(a), 707(c), or 736(b) shall be characterized for purposes of section 469 and the regulations thereunder in accordance with the following rules:

(i) *Section 707(a).* Any item of gross income or deduction attributable to a transaction that is treated under section 707(a) as a transaction between a partnership and a partner acting in a capacity other than as a member of such partnership shall be characterized for purposes of section 469 and the regulations thereunder in a manner that is consistent with the treatment of such transaction under section 707(a).

(ii) *Section 707(c)*—(A) *In general.* Except as provided in paragraph(e)(2)(ii)(B) of this section, any payment to a partner for services or the use of capital that is described in section 707(c) (including any payment described in section 736(a)(2) (relating to guaranteed payments made in liquidation of the interest of a retiring or deceased partner)) shall be characterized as the payment of compensation for services or as the payment of interest, respectively, and not as a distributive share of partnership income.

(B) *Exception.* (*1*) If section 736(a)(2) applies to a payment made in liquidation of a retiring or deceased partner's interest, any income that—

(*i*) Is taken into account by a retiring partner (or any other person that owns (directly or indirectly) an interest in such partner if such partner is a passthrough entity) or a deceased partner's successor in interest as a result of such payment; and

(*ii*) Is attributable to the portion (if any) of such payment that is allocable to the unrealized receivables (within the meaning of section 751(c)) and goodwill of an activity of the partnership; shall be treated as passive activity gross income if and only if the activity was a passive activity of such retiring or deceased partner (or such other person) for the taxable year of such retiring or deceased partner (or such other person) in which the liquidation of such partner's interest commenced.

(*2*) If section 736(a)(2) applies to a payment made in liquidation of a retiring or deceased partner's interest, the portion (if any) of such payment that is allocable to the unrealized receivables (within the meaning of section 751(c)) and goodwill of an activity of the partnership is determined, for purposes of this paragraph (e)(2)(ii)(B), by multiplying the amount of such payment by the fraction obtained by dividing—

(*i*) The amount to be paid under section 736(a)(2) in liquidation of such partner's interest in the unrealized receivables and goodwill of such activity of the partnership; by

(*ii*) The sum of all payments to be made under section 736(a)(2) in liquidation of such partner's interest.

(iii) *Section 736(b).* If any gain or loss is taken into account by a retiring partner (or any other person that owns (directly or indirectly) an interest in such partner if such partner is a passthrough entity) or a deceased partner's successor in interest as a result of a payment to which section 736(b) (relating to payments made in exchange for a retiring or deceased partner's interest in partnership property) applies, such gain or loss shall be treated as passive activity gross income or a passive activity deduction only to the extent that such gain or loss would have been passive activity gross income or a passive activity deduction of such retiring or deceased partner (or such other person) if it had been recognized at the time the liquidation of such partner's interest commenced.

(3) *Sale or exchange of interest in passthrough entity*—(i) *Application of this paragraph (e)(3).* In the case of the sale, exchange, or other disposition (a "disposition") of an interest in a passthrough entity, the amount of the seller's gain or loss from each activity in which such entity has an interest is determined, for purposes of section 469 and the regulations thereunder, under this paragraph (e)(3). In the case of any such disposition, except as otherwise provided in paragraph (e)(3)(iii) or (iv) of this section, paragraph (e)(3)(ii) of this section shall apply. See paragraphs (c)(2) and (d)(5) of this section for rules for determining the character of gain or loss, respectively, recognized upon a disposition of an interest in an activity held through a passthrough entity.

(ii) *General rule*—(A) *Allocation among activities.* Except as otherwise provided in this paragraph (e)(3)(ii) or in paragraph (e)(3) (iii) or (iv) of this section, if a holder of an interest in a passthrough entity disposes of such interest, a ratable portion (within the meaning of paragraph (e)(3)(ii)(B) of this section) of any gain or loss from such disposition shall be treated as gain or loss from the disposition of an interest in each trade or business, rental, or investment activity in which such passthrough entity owns an interest on the applicable valuation date.

(B) *Ratable portion*—(*1*) *Dispositions on which gain is recognized.* The ratable portion of any gain from the disposition of an interest in a passthrough entity that is allocable to an activity described in paragraph (e)(3)(ii)(A) of this section is determined by multiplying the amount of such gain by the fraction obtained by dividing—

(*i*) The amount of net gain (within the meaning of paragraph (e)(3)(ii)(E)(*3*) of this section) that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date; by

(*ii*) The sum of the amounts of net gain that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in each appreciated activity (within the meaning of paragraph (e)(3)(ii)(E)(*1*) of this section) described in paragraph (e)(3)(ii)(A) of this section for the fair market value of each such activity on the applicable valuation date.

(*2*) *Dispositions on which loss is recognized.* The ratable portion of any loss from the disposition of an interest in a passthrough entity that is allocable to an activity described in paragraph (e)(3)(ii)(A) of this section is determined by multiplying the amount of such loss by the fraction obtained by dividing—

(*i*) The amount of net loss (within the meaning of paragraph (e)(3)(ii)(E)(*4*) of this section) that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date; by

(*ii*) The sum of the amounts of net loss that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in each depreciated activity (within the meaning of paragraph (e)(3)(ii)(E)(*2*) of this section) described in paragraph (e)(3)(ii)(A) of this section for the fair market value of each such activity on the applicable valuation date.

(C) *Default rule.* If the gain or loss recognized upon the disposition of an interest in a passthrough entity cannot be allocated under paragraph (e)(3)(ii)(A) of this section, such gain or loss shall be allocated among the activities described in paragraph (e)(3)(ii)(A) of this section in proportion to the respective fair market values of the passthrough entity's interests in such activities at the applicable valuation date, and the gain or loss allocated to each activity of the passthrough entity shall be treated as gain or loss from the disposition of an interest in such activity.

(D) *Special rules.* For purposes of this paragraph (e)(3)(ii), the following rules shall apply:

(*1*) *Applicable valuation date*—(*i*) *In general.* Except as otherwise provided in paragraph (e)(3)(ii)(D)(*1*)(*ii*) of this section, the applicable valuation date with respect to any disposition of an interest in a passthrough entity is whichever one of the following dates is selected by the passthrough entity:

(*a*) The beginning of the taxable year of the passthrough entity in which such disposition occurs; or

(*b*) The date on which such disposition occurs.

(*ii*) *Exception.* If, after the beginning of a passthrough entity's taxable year in which a holder's disposition of an interest in such passthrough entity occurs and before the time of such disposition—

(*a*) The passthrough entity disposes of more than 10 percent of its interest (by value as of the beginning of such taxable year) in any activity;

(*b*) More than 10 percent of the property (by value as of the beginning of such taxable year) used in any activity of the passthrough entity is disposed of; or

(*c*) The holder of such interest contributes to the passthrough entity substantially appreciated property or substantially depreciated property with a total fair market value or adjusted basis, respectively, which exceeds 10 percent of the total fair market value of the holder's interest in the passthrough entity as of the beginning of such taxable year;

then the applicable valuation date shall be the date immediately preceding the date on which such disposition occurs.

(*2*) *Basis adjustments.* Any adjustment to the basis of partnership property under section 743(b) made with respect to the holder of an interest in a partnership shall be taken into account in computing the net gain or net loss that would have been allocated to the holder with respect to such interest if the partnership had sold its entire interest in an activity.

(*3*) *Tiered passthrough entities.* In the case of a disposition of an interest in a passthrough entity (the "subsidiary passthrough entity") by a holder that is also a passthrough entity, any gain or loss from such disposition that is taken into account by any person that owns (directly or indirectly) an interest in such holder shall be allocated among the activities of the subsidiary passthrough entity by applying the rules of this paragraph (e)(3)(ii) to the person taking such gain or loss into account as if such person has been the holder of an interest in such subsidiary passthrough entity and had recognized such gain or loss as a result of a disposition of such interest.

(E) *Meaning of certain terms.* For purposes of this paragraph (e)(3)(ii)—

(*1*) An activity is an appreciated activity with respect to a holder that has disposed of an interest in a passthrough entity if a net gain would have been allocated to the holder with respect to such interest if the passthrough entity has sold its entire interest in such activity for its fair market value on the applicable valuation date;

(*2*) An activity is a depreciated activity with respect to a holder that has disposed of an interest in a passthrough entity if a net loss would have been allocated to the holder with respect to such interest if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date;

(*3*) The term "net gain" means, with respect to the sale of a passthrough entity's entire interest in an activity, the amount by which the gains from the sale of all of the property used by (or representing the interest of) the passthrough entity in such activity exceed the losses (if any) from such sale;

(*4*) The term "net loss" means, with respect to the sale of a passthrough entity's entire interest in an activity, the amount by which the losses from the sale of all of the property used by (or representing the interest of) the passthrough entity in such activity exceed the gains (if any) from such sale.

(iii) *Treatment of gain allocated to certain passive activities as not from a passive activity.* If, in the case of a disposition of an interest in a passthrough entity—

(A) An amount of gain recognized on account of such disposition by the holder of such interest (or any other person that owns (directly or indirectly) an interest in such holder if such holder is a passthrough entity) is allocated to a passive activity of such holder (or such other person) under paragraph (e)(3)(ii) of this section;

(B) An amount of gain that would have been treated as gain that is not from a passive activity under paragraph (c)(2)(iii) of this section (relating to substantially appreciated property formerly used in a nonpassive activity) would have been allocated to such holder (or such other person) with respect to such interest if all of the property used in such passive activity had been sold immediately prior to the disposition for its fair market value on the applicable valuation date (within the meaning of paragraph (e)(3)(ii)(D)(*1*) of this section; and

(C) The amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(B) of this section exceeds 10 percent of the amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(A) of this section;

then the gain of the holder (or such other person) that is described in paragraph (e)(3)(iii)(A) of this section shall be treated as gain that is not from a passive activity to the extent that such gain does not exceed the amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(B) of this section. For purposes of applying the preceding sentence to the disposition of an interest in a partnership, the amount of gain that would have been allocated to the holder (or such other person) if all of the property used in an activity had been sold shall be determined by taking into account any adjustment to the basis of partnership property made with respect to such holder (or such other person) under section 743(b).

(iv) *Dispositions occurring in taxable years beginning before February 19, 1988*—(A) *In general.* Except as otherwise provided in this paragraph (e)(3)(iv), if the holder of an interest in a passthrough entity sells, exchanges, or otherwise disposes of all or part of such interest during a taxable year of such entity beginning prior to February 19, 1988, any gain or loss recognized from such disposition shall be allocated among the activities of the passthrough entity under any reasonable method selected by the passthrough entity, and the gain or loss allocated to each activity of the passthrough entity shall be treated as gain or loss from the disposition of an interest in such activity. For purposes of the preceding sentence, a reasonable method shall include the method prescribed by paragraph (e)(3)(ii) of this section. In addition, a method that allocates gain or loss among the passthrough entity's activities on the basis of the fair market value, cost, or adjusted basis of the property used in such activities shall generally be considered a reasonable method for purposes of this paragraph (e)(3)(iv).

(B) *Exceptions.* This paragraph (e)(3)(iv) shall not apply to any disposition of an interest in a passthrough entity occurring after February 19, 1988, if after such date, but before the holder's disposition of such interest, the holder (or any other person that owns (directly or indirectly) an interest in such holder if such holder is a passthrough entity) contributes to the passthrough entity substantially appreciated portfolio assets or any other substantially appreciated property that was used in any trade or business activity (within the meaning of § 1.469-1T(e)) of the holder (or such other person) during—

(*1*) The taxable year of such person in which such contribution occurs; or

(*2*) The immediately preceding taxable year of such person;

but only if such person materially participated (within the meaning of § 1.469-5T) in the activity for such year.

(v) *Treatment of portfolio assets.* For purposes of the paragraph (e)(3), all portfolio assets owned by a passthrough entity shall be treated as held in a single investment activity.

(vi) *Definitions.* For purposes of this paragraph (e)(3)—

(A) The term "portfolio asset" means any property of a type that produces portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(B) The term "substantially appreciated property" means property with a fair market value that exceeds 120 percent of its adjusted basis; and

(C) The term "substantially depreciated property" means property with an adjusted basis that exceeds 120 percent of its fair market value.

(vii) *Examples.* The following examples illustrate the application of this paragraph (e)(3):

Example (1). (i) A owns a one-half interest in P, a calendar year partnership. In 1993, A sells 50 percent of such interest for $50.000. A's adjusted basis for the interest sold is $30,000. Thus, A recognizes $20,000 of gain from the sale. P is engaged in three trade or business activities, X, Y, and Z, and owns marketable securities that are portfolio assets. For 1993, A materially participates in activity Z, but does not participate in activities X and Y. Paragraph (c)(2)(iii) of this section would not have applied to any of the gain that A would have been allocated if, immediately before A's sale, P had disposed of all of the property used in its trade or business activities. During the portion of 1993 preceding A's sale, P did not sell any of the property used in its activities, and A did not contribute any property to P.

(ii) Under paragraph (e)(3)(ii) of this section, a ratable portion of A's $20,000 gain is allocated to each appreciated activity in which P owned an interest on the applicable valuation date (within the meaning of paragraph (e)(3)(ii)(D)(*1*) of this section). For this purpose, paragraph (e)(3)(v) of this section treats the marketable securities owned by P as a single investment activity.

(iii) P selects the beginning of 1993 as the applicable valuation date pursuant to paragraph (e)(3)(ii)(D)(*1*)(*i*) of this section. P is not required to use the date of A's sale as the applicable valuation date under paragraph (e)(3)(ii)(D)(*1*)(*ii*) of this section because during the portion of 1993 preceding A's sale, P did not sell any of its property and A did not contribute any property to P. At the beginning of 1993, the fair market value and adjusted basis of the property used in P's activities are as follows:

	Adjusted basis	Fair market value
X	$68,000	$48,000
Y	30,000	62,000
Z	20,000	80,000
Marketable securities	2,000	10,000
Total	120,000	200,000

(iv) Under paragraph (e)(3)(ii)(B) of this section, the portion of A's $20,000 gain that is allocated to an appreciated activity of P (i.e., activities Y and Z and the marketable securities) is the amount of such gain multiplied by the fraction obtained by dividing (a) the net gain that would have been allocated to A with respect to the interest sold by A if P had sold its entire interest in such activity at the beginning of 1993 by (b) the sum of the amounts of net gain that would have been allocated to A with respect to the interest sold by A if P had sold its entire interest in each appreciated activity at the beginning of 1993.

(v) If P had sold its entire interest in activities Y and Z and the marketable securities at the beginning of 1993, A would have been allocated the following amounts of net gain with respect to the interest in P that A sold in 1993:

Activity	Net gain
Y	$8,000
Z	15,000
Marketable securities	2,000
Total	25,000

(vi) Accordingly, under paragraph (e)(3)(ii) of this section, $6,400 of A's $20,000 gain ($20,000 × $8,000/$25,000) is allocated to activity Y, $12,000 of A's $20,000 gain ($20,000 × $15,000/$25,000) is allocated to activity Z, and $1,600 of A's $20,000 gain ($20,000 × $2,000/$25,000) is allocated to the marketable securities. The gain allocated to activity Y is passive activity gross income. None of that gain is treated as gain that is not from a passive activity under paragraph (e)(3)(iii) of this section because paragraph (c)(2)(iii) of this section would not have applied to any of the gain that A would have been allocated if P had sold all of the property used in activity Y immediately prior to A's sale.

Example (2). (i) B and C, calendar year individuals, are equal partners in calendar year partnership R, which they formed on January 1, 2005, with contributions of property and money. The only item of property (other than money) contributed by B was a building that B had used for 12 years preceding the contribution in an activity that was not a passive activity during such period. At the time of its contribution, the building had an adjusted basis of $40,000 and a fair market value of $66,000. R is engaged in a single activity: the sale of equipment to customers in the ordinary course of the business of dealing in such property. R uses the building contributed by B in the dealership activity. B did not materially participate in the dealership activity during 2005. On July 1, 2005, D purchases one-half of B's interest in R for $37,500 in cash. At the time of the sale, the balance sheet of R, which uses the accrual method of accounting, is as follows:

	Adjusted basis per books	Fair market value
Assets		
Cash	$30,000	$30,000
Accounts receivable:		
Dealership	20,000	18,000
Inventory:		
Dealership	52,000	66,000
Building	40,000	66,000
Total	142,000	180,000
Liabilities and Capital		
Liabilities	$30,000	$30,000
Capital:		
B	47,000	75,000
C	65,000	75,000
Total	142,000	180,000

Thus, B's gain from the sale is $14,000 ($45,000 amount realized from the sale (consisting of $37,500 of cash and $7,500 of liabilities assumed by the purchaser) minus B's $31,000 adjusted basis for the interest sold (one-half of B's total adjusted basis of $62,000)).

(ii) Under paragraph (e)(3)(ii) of this section, all $14,000 of B's gain from the sale is allocated to R's dealership activity, which is a passive activity of B for 2005. If, however, R had sold its interest in the building immediately prior to B's sale for its fair market value on the applicable valuation date (the valuation date selected by R is irrelevant since the building had a fair market value of $66,000 at the beginning of 2005 and at the time of the sale), B would have been allocated $13,000 of gain under section 704(c) with respect to the interest in R that B sold to D. This gain would have been treated as gain that is not from a passive activity under paragraph (c)(2)(iii) of this section and would have exceeded 10 percent of the total amount of B's gain that is allocated to the dealership activity under paragraph (e)(3)(ii) of this section. Accordingly, under paragraph (e)(3)(iii) of this section, B's gain from the sale ($14,000) is treated as gain that is not from a passive activity to the extent that such gain does not exceed the amount of gain subject to paragraph (c)(2)(iii) of this section that B would have been allocated with respect to the interest sold to D if R had sold all of the property used in the dealership activity immediately prior to B's sale ($13,000). Thus, $13,000 of B's gain from the sale is treated as gain that is not from a passive activity.

(f) *Recharacterization of passive income in certain situations*—(1) *In general.* This paragraph (f) sets forth rules that require income from certain passive activities to be treated as income that is not from a passive activity (regardless of whether such income is treated as passive activity gross income under section 469 or any other provision of the regulations thereunder). For definitions of certain terms used in this paragraph (f), see paragraph (f)(9) of this section.

(2) *Special rule for significant participation*—(i) *In general.* An amount of the taxpayer's gross income from each significant participation passive activity for the taxable year equal to a ratable portion of the taxpayer's net passive income from such activity for the taxable year shall be treated as not from a passive activity if the taxpayer's passive activity gross income from all significant participation passive activities for the taxable year (determined without regard to paragraphs (f) (2) through (4) of this section) exceeds the taxpayer's passive activity deductions from all such activities for such year. For purposes of this paragraph (f)(2), the ratable portion of the net passive income from an activity is determined by multiplying the amount of such income by the fraction obtained by dividing—

(A) The amount of the excess described in the preceding sentence; by

(B) The amount of the excess described in the preceding sentence taking into account only significant participation passive activities from which the taxpayer has net passive income for the taxable year.

(ii) *Significant participation passive activity.* For purposes of this paragraph (f)(2), the term "significant participation passive activity" means any trade or business activity (within the meaning of § 1.469-1T(e)(2)) in which the taxpayer significantly participates (within the meaning of § 1.469-5T(c)(2)) for the taxable year but in which the taxpayer does not materially participate (within the meaning of § 1.469-5T) for such year.

(iii) *Example.* The following example illustrates the application of this paragraph (f)(2):

Example. (i) A owns interests in three trade or business activities, X, Y, and Z. A does not materially participate in any of these activities for the taxable year, but participates in activity X for 110 hours, in activity Y for 160 hours, and in activity Z for 125 hours. A owns no interest in any other trade or business activity in which A does not materially participate for the taxable year but in which A participates for more than 100 hours during the taxable year. A's net passive income (or loss) for the taxable year from activities X, Y, and Z is as follows:

	X	Y	Z
Passive activity gross income	$600	$700	$900
Passive activity deductions	(200)	(1,000)	(300)
Net passive income	400	(300)	600

(ii) Under paragraph (f)(2)(ii) of this section, activities X, Y, and Z are A's only significant participation passive activities for the taxable year. A's passive activity gross income from significant participation passive activities ($2,200) exceeds A's passive activity deductions from significant participation passive activities ($1,500) by $700 for such year. Therefore, under paragraph (f)(2)(i) of this section, a ratable portion of A's gross income from activities X and Z (A's significant participation passive activities with net passive income for the taxable year) is treated as gross income that is not from a passive activity. The ratable portion is determined by dividing (a) the amount by which A's passive activity gross income from significant participation passive activities exceeds A's passive activity deductions from significant participation passive activities for the taxable year ($700) by (b) such excess taking into account only A's significant participation passive activities having net passive income for the taxable year ($1,000). Accordingly, $280 of gross income from activity X ($400 x 700/1000) and $420 of gross income from activity Z ($600 x 700/1000) is treated as gross income that is not from a passive activity.

(3) *Rental of nondepreciable property.* If less than 30 percent of the unadjusted basis of the property used or held for use by customers in a rental activity (within the meaning of § 1.469-1T(e)(3)) during the taxable year is subject to the allowance for depreciation under section 167, an amount of the taxpayer's gross income from the activity equal to the taxpayer's net passive income from the activity shall be treated as not from a passive activity. For purposes of this paragraph (f)(3), the term "unadjusted basis" means adjusted basis determined without regard to any adjustment described in section 1016 that decreases basis. The following example illustrates the application of this paragraph (f)(3):

Example. C is a limited partner in a partnership. The partnership acquires vacant land for $300,000, constructs improvements on the land at a cost of $100,000, and leases the land and improvements to a tenant. The partnership then sells the land and improvements for $600,000, thereby realizing a gain on the disposition. The unadjusted basis of the improvements ($100,000) equals 25 percent of the unadjusted basis of all property ($400,000) used in the rental activity. Therefore, under this paragraph (f)(3), an amount of C's gross income from the activity equal to the net passive income from the activity (which is computed by taking into account the gain from the disposition, including gain allocable to the improvements) is treated as not from a passive activity.

(4) *Net interest income from passive equity-financed lending activity*—(i) *In general.* An amount of the taxpayer's gross income for the taxable year from any equity-financed lending activity equal to the lesser of—

(A) The taxpayer's equity-financed interest income from the activity for such year; and

(B) The taxpayer's net passive income from the activity for such year shall be treated as not from a passive activity.

(ii) *Equity-financed lending activity*—(A) *In general.* For purposes of this paragraph (f)(4), an activity is an equity-financed lending activity for a taxable year if—

(*1*) The activity involves a trade or business of lending money; and

(*2*) The average outstanding balance of the liabilities incurred in the activity for the taxable year does not exceed 80 percent of the average outstanding balance of the interest-bearing assets held in the activity for such year.

(B) *Certain liabilities not taken into account.* For purposes of paragraph (f)(4)(ii)(A)(*2*) of this section, liabilities incurred principally for the purpose of increasing the percentage described in paragraph (f)(4)(ii)(A)(*2*) of this section shall not be taken into account in computing such percentage.

(iii) *Equity-financed interest income.* For purposes of this paragraph (f)(4), the taxpayer's equity-financed interest income from an activity for a taxable year is the amount of the taxpayer's net interest income from the activity for such year multiplied by the fraction obtained by dividing—

(A) The excess of the average outstanding balance for such year of the interest-bearing assets held in the activity over the average outstanding balance for such year of the liabilities incurred in the activity; by

(B) The average outstanding balance for such year of the interest-bearing assets held in the activity.

(iv) *Net interest income.* For purposes of this paragraph (f)(4), the net interest income from an activity for a taxable year is—

(A) The gross interest income from the activity for such year; reduced by

(B) Expenses from the activity (other than interest on liabilities described in paragraph (f)(4)(vi) of this section) for such year that are reasonably allocable to such gross interest income.

(v) *Interest-bearing assets.* For purposes of this paragraph (f)(4), the interest-bearing assets held in an activity include all assets that produce interest income, including loans to customers.

(vi) *Liabilities incurred in the activity.* For purposes of this paragraph (f)(4), liabilities incurred in an activity include all fixed and determinable liabilities incurred in the activity that bear interest or are issued with original issue discount other than debts secured by tangible property used in the activity. In the case of an activity conducted by an entity in which the taxpayer owns a interest, liabilities incurred in an activity include only liabilities with respect to which the entity is the borrower.

(vii) *Average outstanding balance.* For purposes of this paragraph (f)(4), the average outstanding balance of liabilities incurred in an activity or of the interest-bearing assets held in an activity may be computed on a daily, monthly, or quarterly basis at the option of the taxpayer.

(viii) *Example.* The following example illustrates the application of this paragraph (f)(4):

Example: (i) A, a calendar year individual, acquires on January 1, 1988, a limited partnership interest in P, a calendar year partnership. Under the partnership agreement, A has a one percent share of each item of income, gain, loss, deduction, and credit of P. A acquires the partnership interest for $90,000, using $50,000 of unborrowed funds and $40,000 of proceeds of a loan bearing interest at an annual rate of 10 percent. A pays $4,000 of interest on the loan in 1988.

(ii) P's sole activity is a trade or business of lending money. A does not materially participate in the activity for 1988. During 1988, the average outstanding balance of P's interest-bearing assets (including loans to customers, temporary deposits with other lending institutions, and government and corporate securities) is $20 million. P incurs numerous interest-bearing liabilities in connection with its lending activity, including liabilities for deposits taken from customers, unsecured short-term and long-term loans from other lending institutions, and a mortgage loan secured by the building, owned by P, in which P conducts its business. For 1988, the average outstanding balance of all of these liabilities (other than the mortgage loan) is $11 million. None of these liabilities was incurred by P principally for the purpose of increasing the percentage described in paragraph (f)(4)(ii)(*2*) of this section.

(iii) The interest income derived by P for 1988 from its interest-bearing assets is $2.2 million. The interest expense paid by P for 1988 with respect to the liabilities incurred in connection with its lending activity (other than the mortgage loan) is $990,000. P's other expenses for 1988 that are reasonably allocable to P's gross interest income (including expenses for advertising, loan processing and servicing, and insurance, and depreciation on P's building) total $250,000. P's interest expense for 1988 on the mortgage loan secured by the building used in P's lending activity is $50,000. All of the interest expense paid or incurred by P for 1988 is allocated under § 1.63–8T to expeditures in connection with P's lending activity.

(iv) Under paragraph (f)(4)(ii) of this section, P's activity is an equity-financed lending activity for 1988, since, for 1988, the activity involves a trade or business of lending money and the average outstanding balance of the liabilities incurred in the activity ($11 million) does not exceed 80 percent of the average outstanding balance of the interest-bearing assets held in the activity ($20 million). Accordingly, under paragraph (f)(4)(i) of this section, an amount of A's gross income from the activity equal to the lesser of (a) A's equity-financed interest income from the activity for 1988, or (b) A's net passive income from the activity for 1988, is treated as income that is not from a passive activity.

(v) Under paragraph (f)(4)(iii) of this section, A's equity-financed interest income from the activity for 1988 is determined by multiplying A's net interest income from the activity for 1988 by the fraction obtained by dividing $9 million (the excess of the average interest-bearing assets for 1988 over the average interest-bearing liabilities for 1988) by $20 million (the average interest-bearing assets for 1988). Under paragraph (f)(4)(iv) of this section, A's net interest income from the activity for 1988 is $19,000 (A's distributive share of $2.2 million of gross interest income less A's distributive share of $300,000 of expenses described in paragraph (f)(4)(iv)(B) of this section, including interest expense on the mortgage loan). A's distributive share of P's other interest expense ($990,000) is not taken into account in computing A's net interest income for 1988. Accordingly, A's equity-financed interest income from the activity for 1988 is $8,550 ($19,000 x $9 million/$20 million).

(vi) Under paragraph (f)(9)(i) of this section, A's net passive income from the activity for 1988 is determined by taking into account A's distributive share of P's gross income and deductions from the activity for 1988, as well as any interest expense incurred by A individually that is taken into account under § 1.163–8T in determining A's income or loss from the activity for 1988. Assuming that for 1988 all $4,000 of interest expense on the loan that A used to finance the acquisition of A's interest in P is allocated under § 1.163–8T to expenditures of A in connection with the lending activity for 1988, A's net passive income from the activity for 1988 is $5,100, computed as set forth in the following table:

Gross income:	
Interest income	$22,000
Deductions:	
Distributive share of P's expenses from the activity	(12,900)
Interest expense on A's acquisition debt	(4,000)
Net passive income	5,100

(vii) A's net passive income from the activity for 1988 ($5,100) is less than A's equity-financed income form the activity for 1988 ($8,550). Accordingly, under this paragraph (f)(4), $5,100 of A's gross income from the activity for 1988 is treated as not from a passive activity.

(5) *Net income from certain property rented incidental to development activity*—(i) *In general.* An amount of the taxpayer's gross rental activity income for the taxable year from an item of property used in a rental activity for such year equal to the net rental activity income for the year from such item of property shall be treated as not from a passive activity if—

(A) Any gain from the sale, exchange, or other disposition of the item of property is included in the taxpayer's income for the taxable year;

(B) The use of the item of property in an activity involving the rental of such property commenced less than 24 months before the date of the disposition (within the meaning of paragraph (c)(2)(iii)(B) of this section) of such property; and

(C) The taxpayer materially participated (within the meaning of § 1.469–5T, but without regard to paragraph (e) thereof) or significantly participated (within the meaning of § 1.469–5T(c)(2)) for any taxable year in an activity that involved for such year the performance of services for the purpose of enhancing the value of such item of property (or any other item of property if the basis of the item of property that is sold, exchanged, or otherwise disposed of is determined in whole or in part by reference to the basis of such other item of property).

(ii) *Commencement of use.* For purposes of paragraph (f)(5)(i)(B) of this section, the use of an item of property in an activity involving the rental of such property commences when substantially all of the property is first held out for rent and is in a state of readiness for rental.

(iii) *Services performed for the purpose of enhancing the value of property.* For purposes of paragraph (f)(5)(i)(C) of this section, services that are treated as performed for the purpose of enhancing the value of an item of property include but are not limited to—

(A) Construction;

(B) Renovation; and

(C) Lease-up (but only if, as of the time the taxpayer commences using the property in the activity described in paragraph (f)(5)(i)(B), a substantial portion of the property is not leased).

(iv) *Example.* The following example illustrates the application of this paragraph (f)(5):

Example. (i) A, a calendar year individual, is a partner in calendar year partnership P, which is engaged in an activity of developing commercial real estate. In 1988, P acquires an interest in undeveloped land, and arranges for the financing and construction of an office building on the land. Beginning on March 1, 1990, substantially all of the building is held out for rent and is in a state of readiness for rental.

(ii) P holds the building for rent for the remainder of 1990 and all of 1991 and 1992, and sells the building on January 15, 1993, pursuant to a contract entered into on January 15, 1992. P did not hold the building for sale to customers in the ordinary course of P's trade or business (see § 1.469–1T (e)(3)(vi)(D)). A's distributive share of P's taxable losses from the rental of the building is $50,000, $30,000, and $30,000, respectively, for 1990, 1991, and 1992. All of A's losses from the rental of the building are disallowed under § 1.469–1T (a)(1)(i). A's distributive share of the gain recognized by P on the sale of the building is $150,000. A has no other gross income or deductions from the activity of renting the building.

(iii) For purposes of paragraph (f)(5)(i)(C), in 1988, 1989, and 1990, P's real estate development activity involves the performance of services for the purpose of enhancing the value of the building. In 1993, the building is sold, and the date on which the use of the building in the rental activity commenced (March 1, 1990) was less then 24 months before the date on which a binding contract for such sale was entered into (January 15, 1992). Accordingly, if A materially participated in P's real estate development activity in 1988, 1989, or 1990 (without regard to whether A materially participated in the activity in more than one of those years), an amount of A's gross rental activity income for 1993 from the building equal to A's net rental activity income for 1993 from such building ($150,000—$110,000 of previously disallowed deductions = $40,000) is treated under this paragraph (f)(5) as gross income that is not from a passive activity.

(6) *Property rented to a nonpassive activity.* An amount of the taxpayer's gross rental activity income for the taxable year from an item of property used in a rental activity for such year equal to the net rental activity income for the year from such item of property shall be treated as not from a passive activity if such property—

(i) Is rented for use in a trade or business activity (within the meaning of § 1.469-1T (e)(2)) in which the taxpayer materially participates (within the meaning of § 1.469-5T, but without regard to paragraph (e) thereof) for the taxable year; and

(ii) Is not described in paragraph (f)(5) of this section.

(7) *Special rules applicable to the acquisition of an interest in a passthrough entity engaged in the trade or business of licensing intangible property*—(i) *In general.* If a taxpayer acquires an interest in an entity described in paragraph (c)(3)(iii)(B)(*3*) of this section (the "development entity") after the development entity has created an item of intangible property or performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property, an amount of the taxpayer's gross royalty income for the taxable year from such item of property equal to the taxpayer's net royalty income for the year from such item of property shall be treated as not from a passive activity.

(ii) *Royalty income from property.* For purposes of this paragraph (f)(7)—

(A) A taxpayer's gross royalty income for a taxable year from an item of property is the taxpayer's share of passive activity gross income for such year (determined without regard to paragraphs (f)(2) through (7) of this section) from the licensing or transfer of any right in such property; and

(B) A taxpayer's net royalty income for a taxable year from an item of property is the excess, if any, of—

(*1*) The taxpayer's gross royalty income for the taxable year from such item of property; over

(*2*) Any passive activity deductions for such taxable year (including any deduction treated as a deduction for such year under § 1.469-1T (f)(4)) that are reasonably allocable to such item of property.

(iii) *Exceptions.* Paragraph (f)(7)(i) of this section shall not apply to a taxpayer's gross royalty income for a taxable year from the licensing of an item of intangible property if—

(A) The expenditures reasonably incurred by the development entity for the taxable year of the entity ending with or within the taxpayer's taxable year with respect to the development or marketing of such property satisfy paragraph (c)(3)(iii)(B)(*2*)(*ii*) (*a*) of this section; or

(B) The taxpayer's share of the expenditures reasonably incurred by the development entity with respect to the development or marketing of such property for all taxable years of the entity beginning with the taxable year of the entity in which the taxpayer acquired the interest in the entity and ending with the taxable year of the entity ending with or within the taxpayer's current taxable year exceeds 25 percent of the fair market value of the taxpayer's interest in such property at the time the taxpayer acquired the interest in the entity.

(iv) *Capital expenditures.* For purposes of paragraph (f)(7)(iii)(B) of this section, a capital expenditure shall be taken into account for the taxable year of the entity in which such expenditure is chargeable to capital account, and the taxpayer's share of such expenditure shall be determined as though such expenditure were allowed as a deduction for such year.

(v) *Example.* The following example illustrates the application of this paragraph (f)(7):

Example. (i) The facts are the same as in example (5) in paragraph (c)(3)(iv) of this section, except that, in 1988, D's 10 percent partnership interest is sold to F for $13,000, all of which is attributable to the design licensed by the partnership.

(ii) For 1988, the expenditures reasonably incurred by the partnership with respect to the development or marketing of the design satisfy paragraph (c)(3)(iii)(B)(*2*)(*ii*)(*a*) of this section. Accordingly, under paragraph (f)(7)(iii)(A) of this section, paragraph (f)(7)(i) of this section does not apply to F's distributive share of the partnership's gross income from licensing the design.

(iii) For 1989, the expenditures reasonably incurred by the partnership with respect to the development or marketing of the design do not satisfy paragraph (c)(3)(iii)(B)(*2*)(*ii*)(*a*) of this section. Moreover, F's distributive share of such expenditures reasonably incurred by the partnership for 1988 and 1989 ($27,000 x .10 = $2,700) does not exceed 25 percent of the fair market value of F's interest in the design at the time F acquired the partnership interest ($13,000). Accordingly, neither of the exceptions provided in paragraph (f)(7)(iii) of this section applies for 1989 and, under paragraph (f)(7)(i) of this section, an amount of F's gross royalty income from the design equal to F's net royalty income from the design is treated as not from a passive activity.

(8) *Limitation on recharacterized income.* The amount of gross income from an activity that is treated as not from a passive activity for the taxable year under subparagraphs (f) (2) through (4) of this paragraph (f) shall not exceed the greatest amount of gross income treated as not from a passive activity under any one of such subparagraphs.

(9) *Meaning of certain terms.* For purposes of this paragraph (f), the terms set forth below shall have the following meanings:

(i) The net passive income from an activity for a taxable year is the amount by which the taxpayer's passive activity gross income from the activity for the taxable year (determined without regard to paragraphs (f) (2) through (4) of this section) exceeds the taxpayer's passive activity deductions from the activity for such year;

(ii) The net passive loss from an activity for a taxable year is the amount by which the taxpayer's passive activity deductions from the activity for the taxable year exceeds the taxpayer's passive activity gross income from the activity for such year (determined without regard to paragraphs (f) (2) through (4) of this section).

(iii) The gross rental activity income for a taxable year from an item of property used in a rental activity for such year is any passive activity gross income for such year (determined without regard to paragraphs (f) (2) through (6) of this section) from the rental or disposition of such item of property; and

(iv) The net rental activity income from an item of property for a taxable year is the excess, if any, of—

(A) The gross rental activity income from such item of property for the taxable year; over

(B) Any passive activity deductions for such taxable year (including any deduction treated as a deduction for such year under § 1.469-1T(f)(4)) that are reasonably allocable to the use of such item of property in the rental activity.

(10) *Coordination with section 163(d).* Gross income that is treated as not from a passive activity under paragraph (f) (3), (4), or (7) of this

section shall be treated as income described in section 469 (e)(1)(A) and paragraph (c)(3)(i) of this section except in determining whether—

(i) Any property is treated for purposes of section 469(e)(1)(A)(ii)(I) and paragraph (c)(3)(i)(C) of this section as property that produces income of a type described in paragraph (c)(3)(i)(A) of this section;

(ii) An expense (other than interest expense) is treated for purposes of section 469(e)(1)(A)(i)(II) and paragraph (d)(4) of this section as clearly and directly allocable to portfolio income (within the meaning of paragraph (c)(3)(i) of this section); and

(iii) Interest expense is allocated under § 1.163-8T to an investment expenditure (within the meaning of § 1.163-8T(b)(3)) or to a passive activity expenditure (within the meaning of § 1.163-8T(b)(4)).

(11) *Effective date.* For the effective date of the rules in this paragraph (f), see § 1.469-11T (relating to effective date and transition rules).

§ 1.469-3T Passive activity credit (temporary).

(a) *Computation of passive activity credit.* The taxpayer's passive activity credit for the taxable year is the amount (if any) by which—

(1) The sum of all of the taxpayer's credits that are subject to section 469 for such year; exceeds

(2) The taxpayer's regular tax liability allocable to all passive activities for such year.

(b) *Credits subject to section 469*—(1) *In general.* Except as otherwise provided in this paragraph (b), a credit is subject to section 469 for a taxable year if and only if—

(i) Such credit—

(A) Is attributable to such taxable year and arises in connection with the conduct of an activity that is a passive activity for such taxable year; and

(B) Is decribed in—

(*1*) Section 38(b) (1) through (5) (relating to general business credits);

(*2*) Section 27(b) (relating to corporations described in section 936);

(*3*) Section 28 (relating to clinical testing of certain drugs); or

(*4*) Section 29 (relating to fuel from nonconventional sources); or

(ii) Such credit is allocable to an activity for such taxable year under § 1.469-1T(f)(4).

(2) *Treatment of credits attributable to qualified progress expenditures.* Any credit attributable to an increase in qualified investment under section 46(d)(1)(A) (relating to qualified progress expenditures) with respect to progress expenditure property (as defined in section 46(d)(2)) is subject to section 469 for a taxable year if—

(i) Such credit is attributable to such taxable year;

(ii) Such credit is described in paragraph (b)(1)(i)(B) of this section; and

(iii) It is reasonable to believe that such progress expenditure property will be used in a passive activity of the taxpayer when it is placed in service.

(3) *Special rule for partners and S corporation shareholders.* The character of a credit of a taxpayer arising in connection with an activity conducted by a partnership or S corporation (as a credit subject to section 469) shall be determined, in any case in which participation is relevant, by reference to the participation of the taxpayer in such activity. Such participation is determined for the taxable year of the partnership or S corporation (and not the taxable year of the taxpayer). See § 1.469-2T(e)(1).

(4) *Exception for pre-1987 credits.* A credit is not subject to section 469 if it is attributable to a taxable year of the taxpayer beginning prior to January 1, 1987.

(c) *Taxable year to which credit is attributable.* A credit is attributable to the taxable year in which such credit would be (or would have been) allowed if the credits regard to the limitations contained in sections 26(a), 28(d)(2), 29(b)(5), 38(c), and 469.

(d) *Regular tax liability allocable to passive activities*—(1) *In general.* For purposes of paragraph (a)(2) of this section, the taxpayer's regular tax liability allocable to all passive activities for the taxable year is the excess (if any) of—

(i) The taxpayer's regular tax liability for such taxable year; over

(ii) The amount of such regular tax liability determined by reducing the taxpayer's income for such year by the excess (if any) of the taxpayer's passive activity gross income for such year over the taxpayer's passive activity deductions for such year.

(2) *Regular tax liability.* For purposes of this section, the term "regulary tax liability" has the meaning given such term in section 26(b).

(e) *Coordination with section 39.* For purposes of section 39 (relating to the carryback and carryforward of unused business credits), any credit described in section 38(b) (1) through (5) is treated as a current year business credit for the first taxable year in which such credit is subject to section 469 and is not disallowed by section 469 and the regulations thereunder.

(f) *Examples.* The following examples illustrate the application of this section:

Example (1). (i) A, a calendar year individual, is a general partner in calendar year partnership P. P purchases a building in 1987 and, in 1987, 1988, and 1989, incurs rehabilitation costs with respect to the building. The building is placed in service in the rental activity in 1989. P's rehabilitation costs are qualified rehabilitation expenditures (within the meaning of section 48(g)(2)) and are taken into account in determining the amount of the investment credit for rehabilitation expenditures. P's qualified rehabilitation expenditures are not qualified progress expenditures (within the meaning of section 46(d)).

(ii) Because, under section 46(c)(1), the credit is allowable for the taxable year in which the rehabilitated property is placed in service, the credit allowable for P's qualified rehabilitation expenditures arises in connection with the activity in which the property is placed in service. In addition, the credit is attributable to 1989, the year in which the property is placed in service, because it would be allowed for such year if A's credits allowed for all taxable years were determined without regard to the limitations contained in sections 26(a), 28(d)(2), 29(b)(5), 38(c), and 469. Accordingly, under paragraph (b)(1) of this section, A's distributive share of the credit is subject to section 469 for 1989 because the credit arises in connection with a rental activity for such year.

Example (2). The facts are the same as in example (1), except that the rehabilitation costs are incurred in anticipation of placing the building in service in a rental activity, the qualified rehabilitation expenditures in 1987 and 1988 are qualified progress expenditures ("QPEs") (within the meaning of section 46(d)(3)), the improvements resulting from the expenditures are progress expenditure property (within the meaning of paragraph (d)(2) of this section), and it is reasonable to expect that such property will be transition property (within the meaning of section 49(e)) when the property is placed in service. Therefore, under section 46(d)(1)(A), the qualified investment for 1987 and 1988 is increased by an amount equal to the aggregate of the applicable percentage of the qualified rehabilitation expenditures incurred in such years. The credits that are based on these expenditures are attributable (under paragraph (c) of this section) to 1987 and 1988, respectively. It is reasonable to believe in 1987 and 1988 that the progress expenditure property will be used in a rental activity when it is placed in service. Accordingly, under paragraph (b)(2) of this section, A's distributive share of the credit for 1987 and 1988 is subject to section 469. Under paragraph (b)(1) of this section (as in example (1)), A's distributive share of the credit for 1989 is also subject to section 469.

Example (3). (i) B, a single individual, acquires an interest in a partnership that, in 1988, rehabilitates a building and places it in service in a trade or business activity in which B does not materially participate. For 1988, B has the following items of gross income, deduction, and credit:

Gross income:		
Income other than passive activity gross income	$110,000	
Passive activity gross income	20,000	$130,000
Deductions:		
Deductions other than passive activity deductions	23,950	
Passive activity deductions	18,000	(41,950)
Taxable income		88,050
Credits:		
Rehabilitation credit from the passive activity		8,000

(ii) For 1988, the amount by which B's passive activity gross income exceeds B's passive activity deductions (B's net passive income) is $2,000. Under paragraph (d) of this section, B's regular tax liability allocable to passive activities for 1988 is determined as follows:

(A) Taxable income	$88,050	
(B) Regular tax liability		$24,578.50
(C) Taxable income minus net passive income	86,050	
(D) Regular tax liability for taxable income of $86,050.00		23,918.50
(E) Regular tax liability allocable to passive activities ((B) minus (D))		$660.00

(iii) Under paragraph (a) of this section, B's passive activity credit for 1988 is the amount by which B's credits that are subject to section 469 for 1988 ($8,000) exceed B's regular tax liability allocable to passive activities for 1988 ($660.00). Accordingly, B's passive activity credit for 1988 is $7,340.

Example (4). (i) The facts are the same as in example (3) except that, in 1988, B also has additional deductions of $100,000 from a trade or business activity in which B materially participates for 1988. Thus, B has a taxable loss for 1988 of $11,950, determined as follows:

Gross income:		
Income other than passive activity gross income	$110,000	
Passive activity gross income	20,000	$130,000
Deductions:		
Deductions other than passive activity deductions	123,950	
Passive activity deductions	18,000	(141,950)
Taxable income		(11,950)

(ii) Under section 26(b) and paragraph (d)(2) of this section, the regular tax liability for a taxable year cannot exceed the tax imposed by chapter 1 of subtitle A of the Internal Revenue Code for the taxable year. Therefore, under paragraph (d)(1) of this section, B's regular tax liability allocable to passive activities for 1988 is zero. Although B's net operating loss for the taxable year is reduced by B's net passive income, and B's regular tax liability for other taxable years may increase as a result of the reduction, such an increase does not change B's regular tax liability allocable to passive activities for 1988. Accordingly, B's passive activity credit for 1988 is $8,000.

§ 1.469–4T Definition of activity (temporary). [Reserved]

§ 1.469–5T Material participation (temporary).

(a) *In general.* Except as provided in paragraphs (e) and (h)(2) of this section, an individual shall be treated, for purposes of section 469 and the regulations thereunder, as materially participating in an activity for the taxable year if and only if—

(1) The individual participates in the activity for more than 500 hours during such year;

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;

(4) The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;

(5) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

(6) The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or

(7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

(b) *Facts and circumstances*—(1) *In general.* [Reserved]

(2) *Certain participation insufficient to constitute material participation under this paragraph (b)* —(i) *Participation satisfying standards not contained in section 469.* Except as provided in section 469(h)(3) and paragraph (h)(2) of this section (relating to certain retired individuals and surviving spouses in the case of farming activities), the fact that an individual satisfies the requirements of any participation standard (whether or not referred to as "material participation") under any provision (including sections 1402 and 2032A and the regulations thereunder) other than section 469 and the regulations thereunder shall not be taken into account in determining whether such individual materially participates in any activity for any taxable year for purposes of section 469 and the regulations thereunder.

(ii) *Certain management activities.* An individual's services performed in the management of an activity shall not be taken into account in determining whether such individual is treated as materially participating in such activity for the taxable year under paragraph (a)(7) of this section unless, for such taxable year—

(A) No person (other than such individual) who performs services in connection with the management of the activity receives compensation described in section 911(d)(2)(A) in consideration for such services; and

(B) No individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by such individual.

(iii) *Participation less than 100 hours.* If an individual participates in an activity for 100 hours or less during the taxable year, such individual shall not be treated as materially participating in such activity for the taxable year under paragraph (a)(7) of this section.

(c) *Significant participation activity* —(1) *In general.* For purposes of paragraph (a)(4) of this section, an activity is a significant participation activity of an individual if and only if such activity—

(i) Is a trade or business activity (within the meaning of § 1.469–1T(e)(2)) in which the individual significantly participates for the taxable year; and

(ii) Would be an activity in which the individual does not materially participate for the taxable year if material participation for such year were determined without regard to paragraph (a)(4) of this section.

(2) *Significant participation.* An individual is treated as significantly participating in an activity for a taxable year if and only if the individual participates in the activity for more than 100 hours during such year.

(d) *Personal service activity.* An activity constitutes a personal service activity for purposes of paragraph (a)(6) of this section if such activity involves the performance of personal services in—

(A) The fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or

(B) Any other trade or business in which capital is not a material income-producing factor.

(e) *Treatment of limited partners*—(1) *General rule.* Except as otherwise provided in this paragraph (e), an individual shall not be treated as materially participating in any activity of a limited partnership for purposes of applying section 469 and the regulations thereunder to—

(i) The individual's share of any income, gain, loss, deduction, or credit from such activity that is attributable to a limited partnership interest in the partnership; and

(ii) Any gain or loss from such activity recognized upon a sale or exchange of such an interest.

(2) *Exceptions.* Paragraph (e)(1) of this section shall not apply to an individual's share of income, gain, loss, deduction, and credit for a taxable year from any activity in which the individual would be treated as materially participating for the taxable year under paragraph (a)(1), (5), or (6) of this section if the individual were not a limited partner for such taxable year.

(3) *Limited partnership interest*—(i) *In general.* Except as provided in paragraph (e)(3)(ii) of this section, for purposes of section 469(h)(2) and this paragraph (e), a partnership interest shall be treated as a limited partnership interest if—

(A) Such interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law; or

(B) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractural obligations to make additional capital contributions to the partnership).

(ii) *Limited partner holding general partner interest.* A partnership interest of an individual shall not be treated as a limited partnership interest for the individual's taxable year if the individual is a general partner in the partnership at all times during the partnership's taxable year ending with or within the individual's taxable year (or the portion of the partnership's taxable year during which the individual (directly or indirectly) owns such limited partnership interest).

(f) *Participation*—(1) *In general.* Except as otherwise provided in this paragraph (f), any work done by an individual (without regard to the capacity in which the individual does such work) in connection with an activity in which the individual owns (directly or indirectly, other than through a C corporation) an interest at the time the work is done shall be treated for purposes of this section as participation of such individual in the activity.

(2) *Exceptions*—(i) *Certain work not customarily done by owners.* Work done in connection with an activity shall not be treated as participation in the activity for purposes of this section if—

(A) Such work is not of a type that is customarily done by an owner of such an activity; and

(B) One of the principal purposes for the performance of such work is to avoid the disallowance, under section 469 and the regulations thereunder, of any loss or credit from such activity.

(ii) *Participation as an investor*—(A) *In general.* Work done by an individual in the individual's capacity as an investor in an activity shall not be treated as participation in the activity for purposes of this section unless the individual is directly involved in the day-to-day management or operations of the activity.

(B) *Work done in individual's capacity as an investor.* For purposes of this paragraph (f)(2)(ii), work done by an individual in the individual's capacity as an investor in an activity includes—

(*1*) Studying and reviewing financial statements or reports on operations of the activity;

(*2*) Preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use; and

(*3*) Monitoring the finances or operations of the activity in a non-managerial capacity.

(3) *Participation of spouse.* In the case of any person who is a married individual (within the meaning of section 7703) for the taxable year, any participation by such person's spouse in the activity during the taxable year (without regard to whether the spouse owns an interest in the activity and without regard to whether the spouses file a joint return for the taxable year) shall be treated, for purposes of applying section 469 and the regulations thereunder to such person, as participation by such person in the activity during the taxable year.

(4) *Methods of proof.* The extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.

(g) *Material participation of trusts and estates.* [Reserved]

(h) *Miscellaneous rules*—(1) *Participation of corporations.* For rules relating to the participation in an activity of a personal service corporation (within the meaning of § 1.468–1T(g)(2)(i)) or a closely held corporation (within the meaning of § 1.469–1T(g)(2)(ii)), see § 1.469–1T(g)(3).

(2) *Treatment of certain retired farmers and surviving spouses of retired or disabled farmers.* An individual shall be treated as materially participating for a taxable year in any trade or business activity of farming it paragraph (4) or (5) of section 2032A(b) would cause the requirements of section 2032A(b)(1)(C)(ii) to be met with respect to real property used in such activity had the individual died during such taxable year.

(i) [Reserved]

(j) *Material participation for taxable years beginning before January 1, 1987.* In any case in which it is necessary to determine whether an individual materially participated in any activity for a taxable year beginning before January 1, 1987 (other than a taxable year of a partnership, S corporation, estate, or trust ending after December 31, 1986), such determination shall be made without regard to paragraphs (a)(2) through (7) of this section.

(k) *Examples.* The following examples illustrate the application of this section:

Example (1). A, a calendar year individual, owns all of the stock of X, a C corporation. X is the general partner, and A is the limited partner, in P, a calendar year partnership. P has a single activity, a restaurant, which is a trade or business activity (within the meaning of § 1.469–1T(e)(2)). During the taxable year, A works for an average of 30 hours per week in connection with P's restaurant activity. Under paragraphs (a)(1) and (e)(2) of this section, A is treated as materially participating in the activity for the taxable year because A participates in the restaurant activity during such year for more than 500 hours. In addition, under § 1.469–1T(g)(3)(i), A's participation will cause X to be treated as materially participating in the restaurant activity.

Example (2). The facts are the same as in example (1), except that the partnership agreement provides that P's restaurant activity is to be managed by X, and A's work in the activity is performed pursuant to an employment contract between A and X. Under paragraph (f)(1) of this section, work done by A in connection with the activity in any capacity is treated as participation in the activity by A. Accordingly, the conclusion is the same as in example (1). The conclusion would be the same if A owned no stock in X at any time, although in that case A's participation would not be taken into account in determining whether X materially participates in the restaurant activity.

Example (3). B, an individual, is employed fulltime as a carpenter. B also owns an interest in a partnership which is engaged in a van conversion activity, which is a trade or business activity (within the meaning of § 1.469–1T(e)(2)). B and C, the other partner, are the only participants in the activity for the taxable year. The activity is conducted entirely on Saturdays. Each Saturday throughout the taxable year, B and C work for eight hours in the activity. Although B does not participate in the activity for more than 500 hours during the taxable year, under paragraph (a)(3) of this section, B is treated for such year as materially participating in the activity because B participates in the activity for more than 100 hours during the taxable year, and B's participation in the activity for such year is not less than the participation of any other person in the activity for such year.

Example (4). C, an individual, is employed full-time as an accountant. C also owns interests in a restaurant and a shoe store. The restaurant and shoe store are trade or business activities (within the meaning of § 1.469–1T(e)(2)) that are treated as separate activities under the rules to be contained in § 1.469–4T. Each activity has several full-time employees. During the taxable year, C works in the restaurant activity for 400 hours and in the shoe store activity for 150 hours. Under paragraph (c) of this section, both the restaurant and shoe store activities are significant participation activities of C for the taxable year. Accordingly, since C's aggregate participation in the restaurant and shoe store activities during the taxable year exceeds 500 hours, C is treated under paragraph (a)(4) of this section as materially participating in both activities.

Example (5). In 1990, D, an individual, acquires stock in an S corporation engaged in a trade or business activity (within the meaning of § 1.469–1T(e)(2)). For every taxable year from 1990 through 1994, D is treated as materially participating (without regard to paragraph (a)(5) of this section) in the activity. D retires from the activity at the beginning of 1995, and would not be treated as materially participating in the activity for 1995 and subsequent taxable years if material participation for such years were determined without regard to paragraph (a)(5) of this section. Under paragraph (a)(5) of this section, however, D is treated as materially participating in the activity for taxable years 1995 through 1999 because D materially participated in the activity (determined without regard to paragraph (a)(5) of this section) for five taxable years during the ten taxable years that immediately precede each of those years. D is not treated under paragraph (a)(5) of this section as materially participating in the activity for taxable years after 1999 because of such years D has not materially participated in the activity (determined without regard to paragraph (a)(5) of this section) for five of the ten immediately preceding taxable years.

Example (6). The facts are the same as in example (5), except that D does not acquire any stock in the S corporation until 1994. Under paragraph (f)(1) of this section, D is not treated as participating in the activity for any taxable year prior to 1994 because D does not own as interest in the activity for any such taxable year. Accordingly, D materially participates in the activity for only one taxable year prior to 1995, and D is not treated under paragraph (a)(5) of this section as materially participating in the activity for 1995 or subsequent taxable years.

Example (7). (i) E, a married individual filing a separate return for the taxable year, is employed full-time as an attorney. E also owns an interest in a professional football team that is a trade or business activity (within the meaning of § 1.469–1T(e)(2)). E does no work in connection with this activity. E anticipates that, for the taxable year, E's deductions from the activity will exceed E's gross income from the activity and that, if E does not materially participate in the activity for the taxable year, part or all of F's passive activity loss for the taxable year will be disallowed under § 1.469–1T(a)(1)(i). Accordingly, E pays E's spouse to work as an office for an average of 15 hours per week during the taxable year.

(ii) Under paragraph (f)(3) of this section any participation in the activity by E's spouse is treated as participation in the activity by E. However, under paragraph (f)(2)(i) of this section, the work done by E's spouse is not treated as participation in the activity because work as an office receptionist is not work of a type customarily done by an owner of a football team, and one of E's principal purposes for paying E's spouse to do this work is to avoid the disallowance under § 1.469–1T(a)(1)(i) of E's passive activity loss. Accordingly, E is not treated as participating in the activity for the taxable year.

Example (8). (i) F, an individual, owns an interest in a partnership that feeds and sells cattle. The general partner of the partnership periodically mails F a letter setting forth certain proposed actions and decisions with respect to the cattle-feeding operation. Such actions and decisions include, for example, what kind of feed to purchase, how much to purchase, and when to purchase it, how often to feed cattle, and when to sell cattle. The letters explain the proposed actions and decisions, emphasize that taking or not taking a particular action or decision is solely within the discretion of F and other partners, and ask F to indicate a decision with respect to each proposed action by answering certain questions. The general partner receives a fee that constitutes earned income (within the meaning of section 911(d)(2)(A)) for managing the cattle-feeding operation. F is not treated as materially participating in the cattle-feeding operation under paragraph (a) (1) through (6) of this section.

(ii) F's only participation in the cattle-feeding operation is to make certain managerial decisions. Under paragraph (b)(2)(ii) of this section, such management services are not taken into account in determining whether the taxpayer is treated as materially participating in the activity for a taxable year under paragraph (a)(7) of this section, if any other person performs services in connection with the management of the activity and receives compensation described in section 911(d)(2)(A) for such services. Therefore, F is not treated as materially participating for the taxable year in the cattle-feeding operation.

§ 1.469–6T Treatment of losses upon certain dispositions (temporary). [Reserved]

§ 1.469–7T Treatment of self-charged items of income and expense (temporary). [Reserved]

§ 1.469–8T Application of section 469 and the regulations thereunder to trusts, estates, and their beneficiaries (temporary). [Reserved]

§ 1.469–9T 189Treatment of income, deductions, and credits from certain rental real estate activities (temporary). [Reserved]

§ 1.469–10T Application of section 469 to publicly traded partnerships (temporary). [Reserved]

§ 1.469–11T Effective date and transition rules (temporary).

(a) *Effective date*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, section 469 and the regulations thereunder apply for taxable years beginning after December 31, 1986.

(2) *Application of certain income recharacterization rules*—(i) *In general.* No amount of gross income shall be treated under § 1.469–2T(f)(3) through (7) as income that is not from a passive activity for any taxable year of the taxpayer beginning before January 1, 1988.

(ii) *Property rented to a nonpassive activity.* In applying § 1.469–2T(f)(6) to a taxpayer's rental of an item of property, the taxpayer's net rental activity income (within the meaning of § 1.469–2T(f)(9)(iv)) from such property for any taxable year beginning after December 31, 1987, shall not include the portion of such income (if any) that is attributable to the rental of such item of property pursuant to a written binding contract entered into before February 19, 1988.

(3) *Qualified low-income housing projects.* For a transitional rule concerning the application of section 469 to losses from qualified low-income housing projects, see section 502 of the Tax Reform Act of 1986.

(4) *Effect of events occurring in years prior to 1987.* The treatment for a taxable year beginning after December 31, 1986, of any item of income, gain, loss, deduction, or credit as an item of passive activity gross income, passive activity deduction, or credit from a passive activity, shall be determined as if section 469 and the regulations thereunder had been in effect for taxable years beginning before January 1, 1987, but without regard to any passive activity loss or passive activity credit that would have been disallowed for any taxable year beginning before January 1, 1987, if section 469 and the regulations thereunder had been in effect for such year. For example, in determining whether a taxpayer materially participates in an activity under § 1.469–5T(a)(5) (relating to taxpayers who have materially participated in an activity for five of the ten immediately preceding taxable years) for any taxable year beginning after December 31, 1986, the taxpayer's participation in the activity for all prior taxable years (including taxable years beginning before 1987) is taken into account. See § 1.469–5T(j) (relating to the determination of material participation for taxable years beginning before January 1, 1987).

(5) *Examples.* The following examples illustrate the application of this paragraph (a):

Example (1). A, a calendar year individual, is a partner in a partnership with a taxable year ending on January 31. During its taxable year ending January 31, 1987, the partnership was engaged in a single activity involving the conduct of a trade or business. In applying section 469 and the regulations thereunder to A for calendar year 1987, A's distributive share of partnership items for the partnership's taxable year ending January 31, 1987, is taken into account. Therefore, under § 1.469–2T(e)(1) and paragraph (a)(4) of this section, A's participation in the activity throughout the partnership's taxable year beginning February 1, 1986, and ending January 31, 1987, is taken into account for purposes of determining the character under section 469 of the items of gross income, deduction, and credit allocated to A for the partnership's taxable year ending January 31, 1987.

Example (2). B, a calendar year individual, is a beneficiary of a trust described in section 651 that has a taxable year ending January 31. The trust conducts a rental activity (within the meaning of § 1.469–1T(e)(3)). Because the trust's taxable year ending January 31, 1987, began before January 1, 1987, section 469 and the regulations thereunder do not apply to the trust for such year. Section 469 and the regulations thereunder do apply, however, to B for B's calendar year 1987. Therefore, income of the trust from the rental activity for the trust's taxable year ending January 31, 1987, that is included in B's gross income for 1987 is taken into account in applying section 469 to B for 1987.

(b) *Transitional rule for pre-enactment loss and pre-enactment credit*—(1) *In general.* For taxable years beginning after December 31, 1986, and before January 1, 1991, § 1.469–1T(a)(1) shall not apply to—

(i) An amount of the passive activity loss equal to the applicable percentage of the pre-enactment loss; and

(ii) An amount of the passive activity credit equal to the applicable percentage of the pre-enactment credit.

(2) *Applicable percentage.* For purposes of this paragraph (b), the applicable percentage of the pre-enactment loss or the pre-enactment credit for a taxable year shall be determined in accordance with the following table:

In the case of a taxable year beginning in:	The applicable percentage is:
1987	65
1988	40
1989	20
1990	10

(3) *Pre-enactment loss.* The pre-enactment loss for any taxable year is the lesser of—

(i) The amount of the passive activity loss that would be disallowed for the taxable year under § 1.469–1T(a)(1)(i) if this section were disregarded; and

(ii) The amount of the passive activity loss that would be disallowed for the taxable year under § 1.469–1T(a)(1)(i) if this section were disregarded and the following items were not taken into account:

(A) Any deduction treated as a deduction from an activity for the taxable year under § 1.469–1T(f)(4); and

(B) Any item from an interest (other than a pre-enactment interest) in any passive activity.

(4) *Pre-enactment credit.* The pre-enactment credit for any taxable year is the lesser of—

(i) The amount of the passive activity credit that would be disallowed for the taxable year under § 1.469–1T(a)(1)(ii) if this section were disregarded; and

(ii) The amount of the passive activity credit that would be disallowed for the taxable year under § 1.469–1T(a)(1)(ii) if this section were disregarded and the following items were not taken into account:

(A) Any deduction or credit treated as a deduction or credit from an activity for the taxable year under § 1.469–1T(f)(4); and

(B) Any item from an interest (other than a pre-enactment interest) in a passive activity.

(5) *Examples.* The following examples illustrate the application of this paragraph (b):

Example (1). A, an individual, owns interest in two passive activities, X and Y. A's interest in activity X is a pre-enactment interest (within the meaning of paragraph (c) of this section), while A's interest in activity Y is not a pre-enactment interest. For 1987 A has a $10,000 loss from activity X and $9,000 of income from activity Y. The amount determined under paragraph (b)(3)(i) of this section is $1,000. The amount determined under paragraph (b)(3)(ii) of this section is $10,000. Therefore, A's pre-enactment loss for 1987 is $1,000. Accordingly, § 1.469-1T(a)(1)(i) does not apply to $650 ($1,000 × .65) of A's $1,000 passive activity loss for 1987.

Example (2). (i) B, an individual, owns an interest in one passive activity, and B's interest in the activity is a pre-enactment interest (within the meaning of paragraph (c) of this section). For 1987 and 1988, B has the following passive activity gross income and passive activity deductions from the activity:

	1987	1988
Gross income	$20,000	$20,000
Deductions	($50,000)	($40,000)

(ii) Under § 1.469-2T(b), B's passive activity loss for 1987 is $30,000 ($50,000 of passive activity deductions minus $20,000 of passive activity gross income). Under paragraph (b)(3) of this section, B's pre-enactment loss for 1987 is $30,000. Accordingly, under paragraphs (b) (1) and (2) of this section, § 1.469-1T(a)(1)(i) does not apply to $19,500 ($30,000 × .65) of B's $30,000 passive activity loss for 1987. Under § 1.469-1T(a)(1)(i), $10,500 of B's loss for 1987 ($30,000 × .35) is disallowed. Under § 1.469-1T(f) (2) and (4), the disallowed loss is allocated among deductions from the activity, and the disallowed deductions are treated as deductions from the activity for 1988.

(iii) For 1988, B's pre-enactment loss is computed as shown in the following table:

	(b)(3)(i)	(b)(3)(ii)
Gross income	$20,000	$20,000
Current deductions	(40,000)	(40,000)
§ 1.469-1T(f)(4)	(10,500)	-0-
Net loss	($30,500)	($20,000)

Therefore, B's pre-enactment loss for 1988 is $20,000.

(iv) Under paragraph (b)(2) of this section, the applicable percentage for 1988 is 40 percent. Therefore, under paragraph (b)(1) of this section § 1.469-1T(a)(1)(i) does not apply to $8,000 ($20,000 × .40) of B's $30,500 passive activity loss for 1988.

Example (3). (i) C, an individual, owns interests in three passive activities, R, S, and T. C's interest in each activity is a pre-enactment interest. For 1987 and 1988, C's gross income, deductions, and net income (loss) from each of the three activities are as follows:

	R	S	T
1987:			
Gross income	$8,000	$5,000	$2,000
Deductions	(9,000)	(7,000)	(1,400)
Net income (loss)	($1,000)	($2,000)	$600
1988:			
Gross income	$7,000	$6,000	$2,000
Deductions	(8,000)	(4,500)	(3,000)
Net income (loss)	($1,000)	$1,500	($1,000)

(ii) Under § 1.469-2T(b), C's passive activity loss for 1987 is $2,400 ($17,400 of passive activity deductions less $15,000 of passive activity gross income). Under paragraph (b)(3) of this section, C's pre-enactment loss for 1987 is $2,400. Accordingly, under paragraph (b)(1) and (2) of this section, § 1.469-1T (a)(1)(i) does not apply to $1,560 ($2,400 × .65) of C's passive activity loss for 1987. Under § 1.469-1T (a)(1)(i), $840 of C's passive activity loss for 1987 ($2,400 x .35) is disallowed.

(iii) Under § 1.469-1T (f)(2)(i), since a portion of C's passive activity loss for 1987 is disallowed, a ratable portion of the loss from each of C's activities that has a loss for 1987 (activity R and activity S) is disallowed for 1987. Accordingly, $280 of the 1987 loss from activity R ($840 × $1,000/$3,000) and $560 of the 1987 loss from activity S ($840 × $2,000/$3,000) is disallowed for 1987. Under § 1.469-1T (f)(2) and (4), corresponding portions of the deductions from each activity are disallowed for 1987 and treated as deductions from activities R and S, respectively, for 1988. The deductions that are disallowed for 1987 and treated as deductions for 1988 are taken into account under paragraph (b)(3)(i) but not paragraph (b)(3)(ii) of this section. Thus, the amounts determined under paragraphs (b)(3)(i) and (b)(3)(ii) of this section for 1988 are as follows:

Activity	(b)(3)(i)	(b)(3)(ii)
R	($1,280)	($1,000)
S	940	1,500
T	(1,000)	(1,000)
Total	($1,340)	($500)

Therefore, C's pre-enactment loss for 1988 is $500.

(iv) Under paragraph (b)(2) of this section, the applicable percentage for 1988 is 40 percent. Therefore, under paragraph (b)(1) of this section, § 1.469-1T (a)(1)(i) does not apply to $200 ($500 × .40) of C's $1,340 passive activity loss for 1988.

Example (4). (i) D, an individual, has interests in there passive activities, X, Y, and Z. Activities X and Y are rental real estate activities (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in which D actively participates (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) for the taxable year. D's interest in activity X is a pre-enactment interest, and D's interest in activity Y is not a pre-enactment interest. Activity Z is not a rental real estate activity, and D's interest in activity Z is not a pre-enactment interest. The amount of income (loss) from each activity for the taxable year is as follows:

Activity	Income (loss)
X (pre-enactment rental)	($40,000)
Y (other rental)	$30,000
Z (other non-rental)	($20,000)

(ii) The amount determined under paragraph (b)(3)(ii) of this section is computed by applying section 469 to D as if D's only interests in passive activities were D's pre-enactment interests in such activities. If D's only interests in passive activities were D's pre-enactment interests in such activities, the amount to which § 1.469-1T (a)(1)(i) would not apply, by reason of section 469(i) and the rules to be contained in § 1.469-9T, would be $25,000. Taking into account all of D's interests in passive activities, the amount to which § 1.469-1T (a)(1)(i) would not apply, by reason of section 469(i) and the rules to be contained in § 1.469-9T, is $10,000. Accordingly, the amounts determined under paragraph (b)(3)(i) and (b)(3)(ii) of this section for the taxable year are as follows:

Activity	(b)(3)(i)	(b)(3)(ii)
X	($40,000)	($40,000)
Y	$30,000	
Z	($20,000)	
Subtotal	($30,000)	($40,000)
§ 469(i) allowance	$10,000	$25,000
Total	($20,000)	($15,000)

Therefore, D's pre-enactment loss for the taxable year is $15,000.

Example (5). E, an individual, has for the taxable year the following items of income, deduction, and credit from passive activities:

	Pre-enactment interests	Other interests	Total
Income (deductions)	$100	($1,00)	-0-
Credits	28	28	$56

For the taxable year, E is subject to tax at a marginal rate of 28 percent. Under § 1.469-3T (d), E's regular tax liability allocable to passive activities for the taxable year is zero. If, however, the only interests in passive activities taken into account were the pre-enactment interests (i.e., if the $100 loss were disregarded), E's regular tax liability allocable to passive activities for the taxable year would be $28. Thus, the amounts determined under paragraphs (b)(4)(i) and (b)(4)(ii) of this section are as follows:

(b)(4)(i)	(b)(4)(ii)
$56	-0-

Therefore, E's pre-enactment credit for the taxable year is zero, and § 1.469-1T (a)(1)(ii) applies to E's $56 passive activity credit for the taxable year.

(c) *Definition of pre-enactment interest*—(1)

Geneal rule. Except as otherwise provided in this paragraph (c), the term "pre-enactment interest" means a qualified interest in a pre-enactment activity.

(2) *Qualified interest*—(i) *In general.* For purposes of this paragraph (c), a qualified interest in an activity is any interest in an activity that was—

(A) Held by the taxpayer on October 22, 1986, and at all times thereafter (but only if the activity existed on October 22, 1986); or

(B) Acquired by the taxpayer after October 22, 1986, directly or indirectly, pursuant to one or more written binding contracts to which the taxpayer was a party on October 22, 1986, and held by the taxpayer at all times after such acquisistion.

See paragraph (c)(7) of this section for rules for determining whether a taxpayer was a party on October 22, 1986, to a written binding contract.

(ii) *Stock in a C corporation.* For purposes of this paragraph (c)(2), stock in a C corporation is not treated as an interest in any activity of the corporation. The following example illustrates the application of this paragraph (c)(2)(ii):

Example. On October 22, 1986, the taxpayer owned all of the stock of a C corporation that conducted a single activity. On December 31, 1986, the corporation liquidated and distributed to the taxpayer the assets used in the activity. Under this paragraph (c)(2)(ii), the taxpayer does not have a qualified interest in the corporation's activity as a result of the liquidation. The result would be the same if, on December 31, 1986, instead of liquidating, the corporation elected under section 1362*(a) to be an S corporation.*

(3) *Pre-enactment activity*—(i) *In general.* For purposes of this paragraph (c), an activity is a pre-enactment activity if—

(A) The activity was being conducted by any person on October 22, 1986; or

(B) At least 50 percent (by value) of the property used in the activity during the taxable year was—

(*1*) In existence or under construction on August 16, 1986; or

(*2*) Acquired or constructed by any person pursuant to a written binding contract (without regard to whether the taxpayer or any person related to the taxpayer was a party to such contract) in effect on August 16, 1986.

(ii) *Character before 1987 irrelevant.* For purposes of this paragraph (c), an activity may be treated as a pre-enactment activity without regard to whether such activity would have been a passive activity of the taxpayer for any taxable year beginning before January 1, 1987, had section 469 and the regulations thereunder been in effect for such year.

(4) *Examples.* The following examples illustrate the application of paragraphs (c) (1), (2), and (3) of this section:

Example (1). On October 22, 1986, the taxpayer owned an interest in property used as a personal residence. After October 22, 1986, the taxpayer ceased to use the property as a personal residence and began to use it in a rental activity. The rental activity is a pre-enactment activity (within the meaning of paragraph (c)(3) of this section) because the property used in the rental activity was in existence on August 16, 1986. The taxpayer did not hold any interest in the rental activity on October 22, 1986, however, because the activity did not exist on that date. In addition, the taxpayer did not acquire an interest in the activity after October 22, 1986, pursuant to a written binding contract to which the taxpayer was a party on such date. Accordingly, the taxpayer's interest in the rental activity is not a qualified interest (within the meaning of paragraph (c)(2) of this section), and the taxpayer does not have a pre-enactment interest in the rental activity.

Example (2). The taxpayer owns an interest in a partnership, which owns property used in a rental activity. The taxpayer acquired the partnership interest pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986. The partnership acquired its interest in the rental property pursuant to written binding contracts to which the partnership was a party on October 22, 1986. Construction of the property used in the rental activity commenced prior to August 16, 1986. Under paragraph (c)(7)(ii) of this section, the taxpayer is treated as a party to the contracts to which the partnership was a party on October 22, 1986. Therefore, the taxpayer's interest in the partnership's rental activity is a qualified interest (within the meaning of paragraph (c)(2) of this section) because the taxpayer is treated as acquiring an interest in the partnership's rental activity pursuant to written binding contracts to which the taxpayer was party on October 22, 1986. Since the property used in the rental activity was under construction on August 16, 1986, the partnership's rental activity is a pre-enactment activity (within the meaning of paragraph (c)(3) of this section). Accordingly, the taxpayer's interest in the partnership's rental activity is a pre-enactment interest.

Example (3). The facts are the same as in example (2), except that the partnership acquired the property after October 22, 1986, pursuant to a contract entered into after October 22, 1986. The taxpayer's interest in the partnership's rental activity is not a pre-enactment interest because such interest was not acquired pursuant to written binding contracts to which the taxpayer was a party on October 22, 1986.

Example (4). The taxpayer owned a pre-enactment interest in an activity on October 22, 1986. After that date, the taxpayer died, and the decedent's interest in the activity passed to the decendent's estate. Since a decedent and the decedent's estate are not the same taxpayer, the estate must independently satisfy the requirements for a pre-enactment interest regardless of the fact that the decendent had a pre-enactment interest in the activity. Since the activity was being conducted by the decedent on October 22, 1986, the activity is a pre-enactment activity (within the meaning of paragraph (c)(3) of this section). Since, however, the estate did not hold any interest in the activity on October 22, 1986, the estate does not have a qualified interest in the activity (within the meaning of paragraph (c)(2) of this section). Accordingly, the estate does not have a pre-enactment interest in the activity.

(5) *Effect of changes in a taxpayer's interest in a pre-enactment activity*—(i) *In general.* If the taxpayer's share for a taxable year of an item of income, gain, loss, deduction, or credit from a pre-enactment activity was increased or decreased at any time after October 22, 1986, and prior to the end of such taxable year (other than pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986), the share of such item that is attributable to the taxpayer's pre-enactment interest in such activity shall be determined by taking into account—

(A) The taxpayer's share for such taxable year of such item as of October 22, 1986; reduced by

(B) The greatest amount at any time subsequent to October 22, 1986, by which the sum of all the decreases in the taxpayer's share for such year of such item (other than decreases pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986) exceeds the sum of all the increases in the taxpayer's share for such year of such item (other than increases pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986).

For purposes of this paragraph (c)(5)(i), the taxpayer's share of an item as of October 22, 1986, is determined by taking into account any written binding contract to which the taxpayer was a party on October 22, 1986.

(ii) *Partnership terminations under section 708(b)(1)(B).* A taxpayer's share for a taxable year of an item of income, gain, loss, deduction, or credit from a pre-enactment activity conducted by a partnership shall not be treated as having increased or decreased at any time after October 22, 1986, solely because the partnership is treated as terminating at any time after such date under section 708(b)(1)(B).

(iii) *Examples.* The following examples illustrate the application of this paragraph (c)(5):

Example (1). On October 22, 1986, an individual owned a 10 percent interest in a pre-enactment activity. After October 22, 1986, the taxpayer acquires an additional five percent interest in the activity pursuant to a contract entered into after October 22, 1986. Under this paragraph (c)(5), only the 10 percent interest in the activity the taxpayer owned on October 22, 1986, is a pre-enactment interest.

Example (2). On October 22, 1986, individuals A and B each owned a rental activity. After October 22, 1986, A and B contribute their rental activities to a partnership in exchange for which each receives a 50 percent interest in all items of income, gain, loss, deduction, and credit of the partnership. Under paragraph (c)(5)(i) of this section, A's 50 percent interest in each partnership item attributable to the rental activity contributed by A is attributable to a pre-enactment interest. None of A's interest in the partnership items attributable to the rental activity contributed by B is attributable to a pre-enactment interest.

Example (3). The facts are the same as in example (2), except that under the partnership agreement the items of income, gain, loss, deduction, and credit attributable to the rental activity A contributed to the partnership are allocated 80 percent to A and 20 percent to B. Under paragraph (c)(5)(i) of this section, A's 80 percent interest in each partnership item attributable to the rental activity contributed by A is attributable to a pre-enactment interest.

Example (4). The facts are the same as in example (3) except that on January 1, 1988, the partnership liquidates, distributing to A the rental activity contributed by A to the partnership. Under paragraph (c)(5)(i) of this section, only 80 percent of A's interest in the rental activity distributed to A is a pre-enactment interest.

Example (5). On October 22, 1986, an individual is the general partner in a limited partnership. Under the partnership agreement in effect on that date, the taxpayer is allocated one percent of each item of partnership income, gain, loss, deduction, and credit for 1987 and 10 percent of each such item for 1988. Since the increase was provided for in a written binding contract to which the taxpayer was a party on October 22, 1986, the increase in the taxpayer's share of each item of partnership income, gain, loss, deduction, and credit is taken into account, under paragraph (c)(5)(i) of this section, as income, gain, loss, deduction, and credit from a pre-enactment interest.

Example (6). The facts are the same as in example (5) except that the partnership agreement is amended on November 30, 1986. The amendment decreases the taxpayer's share of partnership depreciation for 1987 from 10 percent to five percent, but does not affect the partner's share of partnership depreciation for any other year. Since the taxpayer's share of partnership depreciation for 1988 is not decreased by the amendment, the result, for 1988, is the same as in example (5). For 1987, however, only five percent of the partnership depreciation is attributable to the taxpayer's pre-enactment interest even if, after November 30, 1986, another amendment to the partnership agreement restores the taxpayer's 10 percent share of partnership depreciation for 1987.

Example (7). (i) A and B, calendar year individuals, own all the stock of X, a calendar year S corporation. On October 22, 1986, A and B each own 50 shares of X stock. On July 1, 1987, X issues an additional 100 shares of stock to B (but does not issue any additional stock to A). On December 1, 1987, A purchases 70 shares of X stock from B. Thus, A and B have the following shares of items of income, gain, loss, deduction, and credit from activities of X:

Period	A's share	B's share
10/22/86–6/30/87	50%	50%
7/1/87–11/30/87	25%	75%
12/1/87–	60%	40%

(ii) Under paragraph (c)(5)(i) of this section, A and B each have a 50 percent share of each item of X as of October 22, 1986. Since there are no increases or decreases in their shares before June 30, 1987, their 50 percent shares of items of X assigned to the period from January 1, 1987, through June 30, 1987, are attributable to their pre-enactment interests.

(iii) As a result of the decrease in A's share on June 30, 1987, only a 25 percent share of the items of X assigned to the period from July 1, 1987, through November 30, 1987, is attributable to A's pre-enactment interest. In addition, notwithstanding the increase in B's share, only a 50 percent share of such items (B's share as of October 22, 1986) is attributable to B's pre-enactment interest.

(iv) As a result of the decrease in B's share on November 30, 1987, only a 40 percent share of the items of X assigned to the period from December 1, 1987, through December 31, 1987, is attributable to B's pre-enactment interest. In addition, notwithstanding the increase in A's share, only a 25 percent share of such items (A's share as of October 22, 1986, reduced by the amount of the decrease in A's share on June 30, 1987) is attributable to A's pre-enactment interest.

(6) *Special rule for beneficiaries of trusts or estates*—(i) *In general.* If a beneficial interest in a trust or estate was held by a taxpayer on October 22, 1986, and at all times thereafter, any income, directly allocable deductions, and credits taken into account by the taxpayer with respect to such interest shall be treated as income, deductions, and credits, respectively, from a pre-enactment interest of the beneficiary if and only if such income, deductions, and credits are from a pre-enactment interest of the trust or estate. For purposes of the preceding sentence, "directly allocable deductions" means—

(A) Depreciation allowable to the beneficiary under section 167(h);

(B) Depletion allowable to the beneficiary under section 611(b)(3); and

(C) Amortization apportioned to the beneficiary under section 642(f). The following example illustrates the application of this paragraph (c)(6)(i):

Example. The taxpayer is a beneficiary of a trust that conducts a rental activity. The trust's interest in the activity is a pre-enactment interest of the trust. On October 22, 1986, under the trust agreement the trustee had discretion to allocate any amount of the depreciation deductions from the rental activity to the beneficiary. Under this paragraph (c)(6)(i), any depreciation deductions from the rental activity that are allocated to the beneficiary will be treated as deductions attributable to a pre-enactment interest of the beneficiary.

(ii) *Interests distributed to beneficiaries.* A beneficiary of a trust or estate to whom the trust or estate distributes an interest in an activity shall be treated as having a pre-enactment interest in the activity by reason of such distribution if and only if such interest was a pre-enactment interest of the trust or estate, and the beneficiary held a beneficial interest in the trust or estate on October 22, 1986, and at all times thereafter.

(7) *Written binding contract*—(i) *In general.* A contract shall be treated as a written binding contract of a person for purposes of this section if and only if the contract is enforceable against such person under the applicable State law and does not limit damages to a specified amount (e.g., by use of a liquidated damages provision). For purposes of the preceding sentence, a contractual provision that limits damages to an amount equal to five percent or more of the total contract price is not treated as limiting damages. In general, a contract is binding upon a person even if it is subject to a condition, as long as the condition is not within the control of such person. A contract is not binding on any date with respect to a person if the contract became enforceable against such person only by reason of an assignment occurring after such date. The following example illustrates the application of this paragraph (c)(7)(i):

Example. As of October 22, 1986, the taxpayer had signed a subscription agreement to acquire an interest in a partnership. The taxpayer's obligation to purchase an interest in the partnership was contingent on other persons signing subscription agreements by a particular date after October 22, 1986, to acquire a minimum number of the total interests offered for sale. If the taxpayer acquires an interest in the partnership, such interest will be treated as acquired pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986. Although the taxpayer's obligation to acquire an interest in the partnership was subject to a contingency, the contingency was not within the taxpayer's control.

(ii) *Special rule for contract of partnership or S corporation*. For purposes of this section, a person shall be treated as a party to a contract on October 22, 1986, if on such date such person is a partner in a partnership or a shareholder in an S corporation (or is bound by a written contract to acquire an interest in such partnership or stock in such corporation) which itself is a party to such contract (or is treated under this paragraph (c)(7)(ii) as a party to such contract) on such date.

(iii) *Application of rule to partnership agreements*. A provision of a partnership agreement shall be treated as a binding contract with respect to a partner if the requirements of this paragraph (c)(7) are otherwise satisfied and such partner does not have the power to amend any provision of the partnership agreement without the consent of other partners.

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impractical to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

LAWRENCE B. GIBBS,
Commissioner of Internal Revenue.

Approved: February 12, 1988.

O. DONALDSON CHAPOTON,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on February 19, 1988, 4:19 p.m., and published in the issue of the Federal Register for February 25, 1988, 53 F.R. 5686)

Section 471.—General Rule for Inventories

26 CFR 1.471-2: Valuation of inventories.

Procedures are provided to allow eligible taxpayers to obtain expeditious consent to discontinue the use of the last-in, first-out (LIFO) inventory method of accounting and to change to an inventory method that is a permitted method. See Rev. Proc. 88-15, page 683.

Section 472.—Last-in, First-out Inventories

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The November 1987 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, November 30, 1987.

Rev. Rul. 88-13

The following price indexes for November 1987 were issued by the Bureau of Labor Statistics on December 22, 1987, for use by department stores, and are accepted by the Internal Revenue Service, under section 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, November 30, 1987.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations—soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100 unless otherwise noted)

Groups	November 1986	November 1987	Percent Change from November 1986 to November 1987[1]
1. Piece Goods	297.6	392.3	−1.3
2. Domestics and Draperies	554.5	572.4	3.2
3. Women's and Children's Shoes	541.0	562.7	4.0
4. Men's Shoes	739.3	769.1	4.0
5. Infants' Wear	525.0	553.4	5.4
6. Women's Underwear	436.3	448.6	2.8
7. Women's and Girls' Hosiery	237.9	238.3	0.2
8. Women's and Girls' Accessories	462.9	489.0	5.6
9. Women's Outerwear and Girls' Wear	359.4	394.0	9.6
10. Men's Clothing	490.3	512.2	4.5
11. Men's Furnishings	493.0	506.6	2.8
12. Boy's Clothing and Furnishings	450.0	453.7	0.8
13. Jewelry	695.6	737.0	6.0
14. Notions	448.1	493.5	10.1
15. Toilet Articles and Drugs	664.5	684.7	3.0
16. Furniture and Bedding	549.7	566.8	3.1
17. Floor Coverings	471.1	480.2	1.9
18. Housewares	719.6	731.4	1.6
19. Major Appliances	246.6	243.8	−1.1
20. Radio and Television	98.4	96.2	−2.2
21. Recreation and Education[2]	100.5	103.7	3.2
22. Home Improvements[2]	100.5	104.4	3.9
23. Auto Accessories[2]	98.9	101.1	2.2
Groups 1-15: Soft Goods	491.6	516.1	5.0
Groups 16-20: Durable Goods	446.5	449.0	0.6
Groups 21-23: Misc. Goods[2]	100.1	103.2	3.2
Store Total	476.4	493.3	3.5

---

[1] Absence of a minus sign before percentage change in this column signifies price increase

[2] Indexes on a January 1986 = 100 base

Section 472

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The December 1987 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, December 31, 1987.

Rev. Rul. 88-20

The following price indexes for December 1987 were issued by the Bureau of Labor Statistics on January 22, 1988, for use by department stores, and are accepted by the Internal Revenue Service, under section 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, December 31, 1987.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations—soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100 unless otherwise noted)

Groups	December 1986	December 1987	Percent Change from December 1986 to December 1987[1]
1. Piece Goods	399.9	389.4	-2.6
2. Domestics and Draperies	554.2	565.6	2.1
3. Women's and Children's Shoes	534.0	559.3	4.7
4. Men's Shoes	744.8	770.3	3.4
5. Infants' Wear	532.1	545.8	2.6
6. Women's Underwear	436.3	435.8	-0.1
7. Women's and Girls' Hosiery	238.9	239.0	0.0
8. Women's and Girls' Accessories	464.4	485.4	4.5
9. Women's Outerwear and Girls' Wear	350.6	378.0	7.8
10. Men's Clothing	481.0	502.9	4.6
11. Men's Furnishings	485.6	500.9	3.2
12. Boys' Clothing and Furnishings	449.9	447.5	-0.5
13. Jewelry	689.0	730.7	6.1
14. Notions	481.4	493.9	2.6
15. Toilet Articles and Drugs	666.6	685.7	2.9
16. Furniture and Bedding	555.2	569.4	2.6
17. Floor Coverings	475.0	486.8	2.5
18. Housewares	722.0	731.1	1.3
19. Major Appliances	246.5	240.1	2.6
20. Radio and Television	98.8	95.4	-3.4
21. Recreation and Education[2]	100.3	103.9	3.6
22. Home Improvements[2]	102.3	103.7	1.4
23. Auto Accessories[2]	99.4	101.5	2.1
Groups 1-15: Soft Goods	487.3	507.2	4.1
Groups 16-20: Durable Goods	448.3	447.7	-0.1
Groups 21-23: Misc. Goods[2]	100.5	103.4	2.9
Store Total	474.9	488.2	2.8

---

[1] Absence of a minus sign before percentage change in this column signifies price increase

[2] Indexes on a January 1986 = 100 base

---

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The January 1988 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, January 31, 1988.

Rev. Rul. 88-26

The following price indexes for January 1988 were issued by the Bureau of Labor Statistics on March 1, 1988, for use by department stores, and are accepted by the Internal Revenue Service, under section 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, January 31, 1988.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations—soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS

(January 1941 = 100 unless otherwise noted)

Groups	January 1987	January 1988	Percent Change from January 1987 to January 1988[1]
1. Piece Goods	406.3	405.0	−0.3
2. Domestics and Draperies	550.5	570.6	3.7
3. Women's and Children's Shoes	521.3	547.1	4.9
4. Men's Shoes	741.0	775.7	4.7
5. Infants' Wear	520.1	545.9	5.0
6. Women's Underwear	424.7	426.7	0.5
7. Women's and Girls' Hosiery	238.4	238.2	−0.1
8. Women's and Girls' Accessories	457.2	474.5	3.8
9. Women's Outerwear and Girls' Wear	338.2	362.1	7.1
10. Men's Clothing	476.6	493.9	3.6
11. Men's Furnishings	479.6	498.1	3.9
12. Boys' Clothing and Furnishings	434.7	434.3	−0.1
13. Jewelry	702.4	745.6	6.2
14. Notions	486.7	495.0	1.7
15. Toilet Articles and Drugs	670.5	691.1	3.1
16. Furniture and Bedding	550.6	568.4	3.2
17. Floor coverings	467.7	491.8	5.2
18. Housewares	725.2	734.6	1.3
19. Major Appliances	247.9	245.1	−1.1
20. Radio and Television	100.6	95.1	−5.5
21. Recreation and Education[2]	100.9	103.5	2.6
22. Home Improvements[2]	103.0	103.4	0.4
23. Auto Accessories[2]	100.1	101.9	1.8
Groups 1–15; Soft goods	479.9	500.9	4.4
Groups 16–20: Durable Goods	450.3	450.0	−0.1
Groups 21–23: Misc. Goods[2]	101.0	103.2	2.2
Store Total	472.0	485.2	2.8

[1] Absence of a minus sign before percentage change in this column signifies price increase

[2] Indexes on a January 1986 = 100 base

---

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The February 1988 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, February 29, 1988.

Rev. Rul. 88-35[1]

The following price indexes for February 1988 were issued by the Bureau of Labor Statistics on March 25, 1988, for use by department stores, and are accepted by the Internal Revenue Service, under section 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, February 29, 1988.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations—soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

---

[1] Corrected by Rev. Rul. 88-35A, 1988-41 I.R.B. 4.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS

(January 1941 = 100 unless otherwise noted)

Groups	February 1987	February 1988	Percent Change from February 1987 to February 1988[1]
1. Piece Goods	398.2	397.7	-0.1
2. Domestics and Draperies	566.5	583.8	3.1
3. Women's and Children's Shoes	519.6	545.2	4.9
4. Men's Shoes	752.5	778.9	3.5
5. Infants' Wear	524.0	537.1	2.5
6. Women's Underwear	429.6	437.0	1.7
7. Women's and Girls' Hosiery	237.1	237.6	0.2
8. Women's and Girls' Accessories	458.3	480.1	4.8
9. Women's Outerwear and Girls' Wear	338.5	360.7	6.6
10. Men's Clothing	478.4	496.5	3.8
11. Men's Furnishings	485.7	498.7	2.7
12. Boys' Clothing and Furnishings	426.8	431.2	1.0
13. Jewelry	707.6	752.5	6.3
14. Notions	486.7	495.8	1.9
15. Toilet Articles and Drugs	672.3	693.7	3.2
16. Furniture and Bedding	549.8	565.5	2.9
17. Floor Coverings	462.8	488.8	5.6
18. Housewares	732.0	728.3	-0.5
19. Major Appliances	248.3	243.6	-1.9
20. Radio and Television	100.1	95.6	-4.5
21. Recreation and Education[2]	100.2	103.8	3.6
22. Home Improvements[2]	103.0	105.1	2.0
23. Auto Accessories[2]	99.8	102.2	2.4
Groups 1-15: Soft Goods	483.3	502.8	4.0
Groups 16-20: Durable Goods	451.3	447.9	-0.8
Groups 21-23: Misc. Goods[2]	100.6	103.7	3.1
Store Total	473.7	486.1	2.6

---

[1] Absence of a minus sign before percentage change in this column signifies price increase

[2] Indexes on a January 1986 = 100 base

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The March 1988 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, March 31, 1988.

Rev. Rul. 88-45

The following price indexes for March 1988 were issued by the Bureau of Labor Statistics on April 22, 1988, for use by department stores, and are accepted by the Internal Revenue Service, under section 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, March 31, 1988.

Indexes are prepared on a national basis for the store total, for 23 major groups of departments, and for three special combinations—soft goods, durable goods and miscellaneous goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, as well as contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS

(January 1941 = 100 unless otherwise noted)

Groups	March 1987	March 1988	Percent Change from March 1987 to March 1988[1]
1. Piece Goods	402.3	409.7	1.8
2. Domestics and Draperies	565.4	594.7	5.2
3. Women's and Children's Shoes	538.7	554.3	2.9
4. Men's Shoes	757.0	782.7	3.4
5. Infants' Wear	539.6	545.6	1.1
6. Women's Underwear	433.0	446.7	3.2
7. Women's and Girls' Hosiery	235.6	242.4	2.9
8. Women's and Girls' Accessories	463.5	486.0	4.9
9. Women's Outerwear and Girls' Wear	363.4	387.4	6.6
10. Men's Clothing	492.1	509.1	3.5
11. Men's Furnishings	491.1	508.9	3.6
12. Boys' Clothing and Furnishings	428.4	437.1	2.0
13. Jewelry	703.4	756.2	7.5
14. Notions	471.6	495.0	5.0
15. Toilet Articles and Drugs	672.8	696.5	3.5
16. Furniture and Bedding	557.9	576.9	3.4
17. Floor coverings	469.3	495.8	5.6
18. Housewares	727.5	732.0	0.6
19. Major Appliances	249.4	243.5	−2.4
20. Radio and Television	99.6	95.6	−4.0
21. Recreation and Education[2]	101.4	104.4	3.0
22. Home Improvements[2]	102.5	103.2	0.7
23. Auto Accessories[2]	100.0	102.0	2.0
Groups 1-15: Soft Goods	494.6	517.0	4.5
Groups 16—20: Durable Goods	451.4	450.6	−0.2
Groups 21—23: Misc. Goods[2]	101.3	103.7	2.4
Store Total	480.4	494.6	3.0

---

[1] Absence of a minus sign before percentage change in this column signifies price increase

[2] Indexes on a January 1986 = 100 base

---

26 CFR 1.472-2: Requirements incident to adoption and use of LIFO inventory method.

Inventories; LIFO; financial conformity requirement. Rev. Ruls. 60-244, 73-66, 74-586, 75-50, 76-379, 76-475, 76-531, 77-50, 77-152, 77-408, 78-49, and 79-58, relating to the financial conformity requirement that applies to taxpayers using the LIFO inventory identification method of accounting, are obsolete.

Rev. Rul. 88-21

PURPOSE

This revenue ruling declares obsolete certain revenue rulings relating to the financial reporting conformity requirement that applies to taxpayers using the last-in, first-out (LIFO) inventory identification method of accounting.

LAW

Section 472(c) of the Internal Revenue Code requires a taxpayer using the LIFO method to use no procedure other than the LIFO method as specified in section 472(b)(1) and (3) in inventorying its goods to ascertain the income, profit, or loss of the first tax year for which the LIFO method is to be used, for the purpose of a report or statement covering such tax year to shareholders, partners, or other proprietors, or to beneficiaries, or for credit purposes. Section 472(e) extends this conformity requirement to subsequent tax years.

T.D. 7756, 1981-1 C.B. 316, published in the Federal Register on January 22, 1981, amended section 1.472-2(e) of the Income Tax Regulations and prescribed comprehensive new rules for complying with the LIFO conformity requirement set forth in section 472(c) and (e) of the Code. Generally, section 1.472-2(e) as amended by T.D. 7756 applies to tax years beginning after December 31, 1953, and ending after August 16, 1954.

HOLDING AND EFFECT ON OTHER DOCUMENTS

Because of the amendments to section 1.472-2(e) of the regulations by T.D. 7756, the following revenue rulings are obsolete:

Rev. Rul. 60-244, 1960-2 C.B. 167
Rev. Rul. 73-66, 1973-1 C.B. 218
Rev. Rul. 74-586, 1974-2 C.B. 156
Rev. Rul. 75-50, 1975-1 C.B. 152
Rev. Rul. 76-379, 1976-2 C.B. 138
Rev. Rul. 76-475, 1976-2 C.B. 139
Rev. Rul. 76-531, 1976-2 C.B. 140
Rev. Rul. 77-50, 1977-1 C.B. 137
Rev. Rul. 77-152, 1977-1 C.B. 138
Rev. Rul. 77-408, 1977-2 C.B. 184
Rev. Rul. 78-49, 1978-1 C.B. 145
Rev. Rul. 79-58, 1979-1 C.B. 187

26 CFR 1.472-2: Requirements incident to adoption and use of LIFO inventory method.

Certain revenue procedures relating to the financial conformity requirement that applies to taxpayers using the LIFO inventory identification method of accounting are obsolete. See Rev. Proc. 88-19, page 695.

26 CFR 1.472-6: Change from LIFO inventory method.

Procedures are provided to allow eligible taxpayers to obtain expeditious consent to discontinue the use of the last-in, first-out (LIFO) inventory method of accounting and to change to an inventory method that is a permitted method. See Rev. Proc. 88-15, page 683.

Part III.—Adjustments

Section 481.—Adjustments Required by Changes in Method of Accounting

26 CFR 1.481-1: Adjustments in general.

Procedures for determining the adjustment period when consent to discontinue the use of the last-in, first-out (LIFO) inventory method is granted. See Rev. Proc. 88-15, page 683.

26 CFR 1.481-1: Adjustments in general.

Guidance is provided with respect to the transitional change in method of accounting under the 1986 Tax Reform Act which repealed section 466 of the Code (qualified discount coupons). See Rev. Rul. 88-30, page 187.

Section 482.—Allocation of Income and Deductions Among Taxpayers

26 CFR 1.482-1: Allocation of income and deductions among taxpayers.

Controlled corporations; allocation of income and deductions. The case of *Foglesong v. Commissioner*, 691 F.2d 848 (7th Cir. 1982), *rev'g* 77 T.C. 1102 (1981), will not be followed by the Service to the extent that the case held that the two trades or businesses requirement of section 482 of the Code is not satisfied when the controlling shareholder works exclusively as an employee of the controlled corporation.

Rev. Rul. 88-38

Foglesong v. Commissioner, 691 F.2d 848 (7th Cir. 1982), *rev'g* 77 T.C. 1102 (1981), concerns an individual who works exclusively for a corporation that is controlled by that individual. The Seventh Circuit considered whether, for purposes of section 482 of the Internal Revenue Code, the individual is engaged in a trade or business separate from the trade or business of the corporation. The case holds, in part, that if such an individual has no trade or business other than working for the corporation, the individual is not engaged in a trade or business separate from that of the corporation and therefore the "two or more organizations, trades, or businesses" requirement of section 482 is not met.

Section 482 of the Code provides that in any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if it is determined that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

The term "organizations, trades, or businesses" is to be construed broadly. H.R. Rep. No. 704, 73rd Cong., 2d Sess. 24 (1934), 1939-1 C.B. (Part 2) 554, 572. Section 482 of the Code contemplates any kind of entity or enterprise that has independent tax significance. *Keller v. Commissioner*, 77 T.C. 1014, 1022 (1981), *aff'd*, 723 F.2d 58 (10th Cir. 1983). The Tax Court in similar cases has consistently taken the position that a shareholder/employee who receives a salary for services rendered is engaged in a trade or business for purposes of section 482. *See Keller; Haag v. Commissioner*, 88 T.C. 604, 615 (1987); *Dolese v. Commissioner*, 82 T.C. 830, 839 (1984), *aff'd*, 811 F.2d 543 (10th Cir. 1987). The dual trade or business requirement of section 482 is satisfied because the corporation is in the business of providing goods or services to customers and the employee is in the business of providing services to the corporation. *See Keller; Haag.*

The purpose of section 482 of the Code is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. Section 1.482-1(b)(1) of the Income Tax Regulations. Allocations under section 482 may be necessary to determine the true taxable incomes of a controlled corporation and its shareholder/employee, notwithstanding the fact that the shareholder/employee works exclusively for the controlled corporation.

In cases to which section 482 of the Code would otherwise be applicable, the Internal Revenue Service does not follow the decision in *Foglesong* to the extent it held that the two trades or businesses requirement of section 482 is not satisfied when the controlling shareholder works exclusively as an employee of the controlled corporation.

26 CFR 1.482-2: Determination of taxable income in specific situations.

T.D. 8204

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Safe-Haven Interest Rates and Rental Charges for Commonly Controlled Taxpayers

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to safe-haven interest rates for certain loans and advances between commonly controlled taxpayers and the deletion of a safe-haven rental charge for the leasing of certain tangible property between controlled taxpayers.

EFFECTIVE DATES: The amendments to the safe-haven interest rates and the safe-haven lease rules are generally effective for loans or advances and for leases entered into after May 8, 1986. The amendments to the interest-free period for intercompany trade receivables (the six month rule) are effective for amounts arising after June 30, 1988.

SUPPLEMENTARY INFORMATION:

BACKGROUND

Proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 482 of the Internal Revenue Code were published in the FEDERAL REGISTER on April 8, 1986 (51 FR 12022, 12035) [LR-189-84, 1986-1 C.B. 820]. The change from fixed to floating safe-haven interest rates under section 482 was proposed to make the safe-haven rates consistent with the interest rates applicable under sections 483 and 1274, as directed by Congress in the Tax Reform Act of 1984 (98 Stat. 494, 531). The proposed amendments would also make other changes to the section 482 regulations, including changing the interest-free period for certain intercompany trade receivables. Many written comments responding to the proposed regulations were received. A public hearing on the proposed regulations was held on November 17, 1986. The final regulations published in this document are adopted after considering all the comments received on the proposed regulations.

EXPLANATION OF THE FINAL REGULATIONS

Safe-haven interest rates

Section 1.482-2(a)(2)(iii) of the final regulations adopts the safe-haven interest rates contained in the proposed regulations without change. The range of safe-haven interest rates generally applicable under the final regulations are from 100 to 130 percent of the applicable Federal rate (AFR) as determined under section 1274(d) in effect on the date a loan between controlled entities is made, effective generally for loans made after May 8, 1986. Comments received on the proposed regulations were generally in favor of using the AFR mechanism to provide floating safe-haven interest rates under section 482, and commentators also favored the proposed range of safe-haven interest rates of from 100 to 130 percent of the AFR.

Interest-free period on intercompany transactions

The prior regulations. Section 1.482-2(a)(3) of the prior regulations provided that interest shall be charged on an indebtedness between controlled entities beginning on the day the indebtedness arises. An exception was provided in the prior regulations for indebtedness incurred in the ordinary course of business from sales, services, etc., between members of the group and not evidenced by a written instrument requiring the payment of interest (hereinafter referred to as "intercompany trade receivables"). Under this exception, interest need not be charged on intercompany trade receivables until six months after the debt arises (the "six month rule"), or until a later date if the taxpayer shows that the regular trade practice conducted by either it or others in its industry permits comparable balances with unrelated parties to remain outstanding for more than six months without charging interest (the "trade practice exception"). The period for which interest need not be charged on intercompany trade receivables is generally referred to as the "interest-free period".

The proposed regulations and comments. Under §1.482-2(a)(1)(iii) of the proposed regulations the six month interest-free period would be reduced to 60-days (the "60-day rule"), but the proposed regulations would also retain the trade practice exception. The definition of intercompany trade receivables is unchanged in the proposed regulations. The prior and the proposed regulations do not distinguish between intercompany trade receivables incurred in a trade or business conducted by the debtor member within the United States, and intercompany trade receivables incurred in a trade or business carried on by the debtor member outside the United States.

Most of the comments received on the proposed regulations addressed the proposed 60-day rule. Commentators stated that a 60-day rule would be commercially unreasonable, burdensome, and inconsistent with the implicit six month interest-free period built into sections 483 and 1274. Commentators also stated that a 60-day rule could require extensive tracing to determine that timely payment has been made. Comments critical of the 60-day rule were most often raised in the context of international intercompany transactions where there may be difficulties in arranging and transmitting payments that are not present in domestic transactions (for example, assembling documents necessary for customs clearing requirements and banking requirements for the purchase of foreign exchange). Commentators also argued that audit adjustments under section 482 requiring the accrual of interest would be more numerous and difficult to perform under a 60-day rule.

The final regulations. The final regulations published in this document provide for a basic interest-free period and for several exceptions to the basic interest-free period for certain classes of intercompany trade receivables. The portions of the final regulations relating to the interest-free period for intercompany trade receivables are effective for intercompany trade receivables arising after June 30, 1988.

Section 1.482-2(a)(1)(iii)(B) of the final regulations provides that interest is not required to be charged on an intercompany trade receivable before the first day of the third calendar month following the month in which the intercompany trade receivable arises. Under §1.482-2(a)(1)(iii)(C) of the final regulations, in the case of intercompany trade receivables incurred by the debtor member of the group in transactions in the ordinary course of a trade or business which is actively conducted by the debtor member outside the United States, interest is not required to be charged on such intercompany trade receivables before the first day of the fourth calendar month following the month in which the intercompany trade receivable arises. Under either of these provisions, the trade practice exception provided in §1.482-2(a)(1)(iii)(D) of the final regulations may be used to lengthen the interest-free period. For purposes of determining the interest-free period, the term "United States" includes any possession of the United States, and the term "foreign country" excludes any possession of the United States.

Under the above rules of the final regulations, the interest-free period on intercompany trade receivables will not be shorter than two full calendar months in the case of domestic intercompany trade receivables, or shorter than three full calendar months in the case of intercompany trade receivables incurred by the debtor member in a foreign business. If the trade practice exception is not used, the interest-free period will end on the last day of a calendar month. In the case of intercompany trade receivables incurred by the debtor member in a foreign business, the interest-free period will always include the end of a fiscal quarter. These rules are intended to simplify administration of a shorter interest-free period: one month's intercompany trade receivables may be treated as a single group having the same interest-free period, thereby limiting the number of intercompany trade receivables that must be tracked for compliance with the interest-free period rules.

Under §1.482-2(a)(1)(iii)(E) of the final regulations an additional exception for determining a longer interest-free period is provided for intercompany trade receivables attributable to related party purchases of property for resale to unrelated persons located in a foreign country. This longer interest-free period is equal to ten (10) calendar days plus the purchasing member's average collection period for sales to unrelated persons located in the same foreign country of products within the same product group that includes the property purchased from the related party. The interest-free period under this exception, however, may not exceed 183 days. This interest-free period is intended to approximate the collection period that the related party seller might have experienced if it made the sale itself.

For purposes of this exception a product group is based upon a three-digit grouping of the Standard Industrial Classification Code (three-digit SIC code). Rules for determining the average collection period are provided in §1.482-2(a)(1)(iii)(E)(*2*) of the final regulations. If the related party purchaser makes sales in more than one foreign country, or sells property in more than one product group in any foreign country, separate computations of its average collection period, by product group within each country, are required. The interest-free period under this exception is not available if the property sold to the unrelated party has been manufactured, produced, or constructed (within the meaning of §1.954-3(a)(4)) by the related party purchaser.

Safe-haven lease rates

The proposed regulations would delete the formula method for determining a safe-haven rental charge for leases of tangible depreciable property between controlled entities. The safe-haven rule for subleases would be retained. No comments were received on these portions of the proposed regulations and they are adopted without charge.

SPECIAL ANALYSES

It has been determined that this final rule is not a major rule as defined in Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required. Although a notice of proposed rulemaking that solicited public comment was issued, it has been concluded that these regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these regulations are not subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

INCOME TAX REGULATIONS
(26 CFR Part 1)

Paragraph 1. The authority citation for Part 1 is amended by adding the following citations:

Authority: 26 U.S.C. 7805. *** Section 1.482-2 also issued under 26 U.S.C. 482.

Par. 2. Paragraphs (a) and (c)(2) of §1.482-2 are revised to read as follows:

§1.482-2 Determination of taxable income in specific situations.

(a) *Loans or advances*—(1) *Interest on bona fide indebtedness*—(i) *In general.* Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest (as defined in paragraph (a)(2) of this section) with respect to such loan or advance, the district director may make appropriate allocations to reflect an arm's length rate of interest for the use of such loan or advance.

(ii) *Application of paragraph (a) of this section*—(A) *Interest on bona fide indebtedness.* Paragraph (a) of this section applies only to determine the appropriateness of the rate of interest charged on the principal amount of a bona fide indebtedness between members of a group of controlled entities, including—

(*1*) Loans or advances of money or other consideration (whether or not evidenced by a written instrument), and

(*2*) Indebtedness arising in the ordinary course of business from sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit.

(B) *Alleged indebtedness.* This paragraph (a) does not apply to so much of an alleged indebtedness which is not in fact a bona fide indebtedness, even if the stated rate of interest thereon would be within the safe haven rates prescribed in paragraph (a)(2)(iii) of this section. For example, paragraph (a) of this section does not apply to payments with respect to all or a portion of such alleged indebtedness where in fact all or a portion of an alleged indebtedness is a contribution to the capital of a corporation or a distribution by a corporation with respect to its shares. Similarly, this paragraph (a) does not apply to payments with respect to an alleged purchase-money debt instrument given in consideration for an alleged sale of property between two controlled entities where in fact the transaction constitutes a lease of the property. Payments made with respect to alleged indebtedness (including alleged stated interest thereon) shall be treated according to their substance. See §1.482-2(a)(3)(i).

(iii) *Period for which interest shall be charged*—(A) *General rule.* This paragraph (a)(1)(iii) is effective for indebtedness arising after June 30, 1988. See 26 CFR §1.482-2(a)(3) (revised as of April 1, 1988) for indebtedness arising before July 1, 1988.

Except as otherwise provided in paragraphs (a)(1)(iii)(B) through (E) of this section, the period for which interest shall be charged with respect to a bona fide indebtedness between controlled entities begins on the day after the day the indebtedness arises and ends on the day the indebtedness is satisfied (whether by payment, offset, cancellation, or otherwise.) Paragraphs (a)(1)(iii)(B) through (E) of this section provide certain alternative periods during which interest is not required to be charged on certain indebtedness. These exceptions apply only to indebtedness described in paragraph (a)(1)(ii)(A)(*2*) of this section (relating to indebtedness incurred in the ordinary course of business from sales, services, etc., between members of the group) and not evidenced by a written instrument requiring the payment of interest. Such amounts are hereinafter referred to as "intercompany trade receivables". The period for which interest is not required to be charged on intercompany trade receivables under this paragraph (a)(1)(iii) is called the "interest-free period". In general, an intercompany trade receivable arises at the time economic performance occurs (within the meaning of section 461(h) and the regulations thereunder) with respect to the underlying transaction between controlled entities. For purposes of this paragraph (a)(1)(ii), the term "United States" includes any possession of the United States, and the term "foreign country" excludes any possession of the United States.

(B) *Exception for certain intercompany transactions in the ordinary course of business.* Interest is not required to be charged on an intercompany trade receivable until the first day of the third calendar month following the month in which the intercompany trade receivable arises.

(C) *Exception for trade or business of debtor member located outside the United States.* In the case of an intercompany trade receivable arising from a transaction in the ordinary course of a trade or business which is actively conducted outside the United States by the debtor member, interest is not required to be charged until the first day of the fourth calendar month following the month in which such intercompany trade receivable arises.

(D) *Exception for regular trade practice of creditor member or others in creditor's industry.* If the creditor member or unrelated persons in the creditor member's industry, as a regular trade practice, allow unrelated parties a longer period without charging interest than that described in paragraph (a)(1)(iii)(B) or (C) of this section (whichever is applicable) with respect to transactions which are similar to transactions that give rise to intercompany trade receivables, such longer interest-free period shall be allowed with respect to a comparable amount of intercompany trade receivables.

(E) *Exception for property purchased for resale in a foreign country*—(*1*) *General rule.* If in the ordinary course of business one member of the group (the "related purchaser") purchases property from another member of the group (the "related seller") for resale to unrelated persons located in a particular foreign country, the related purchaser and the related seller may use as the interest-free period for the intercompany trade receivables arising during the related seller's taxable year from the purchase of such property within the same product group an interest-free period equal the sum of—

(*i*) The number of days in the related purchaser's average collection period (as determined under paragraph (a)(1)(iii)(E)(*2*) of this section) for sales of property within the same product group sold in the ordinary course of business to unrelated persons located in the same foreign country, plus

(*ii*) Ten (10) calendar days.

The interest-free period under this paragraph (a)(1)(iii)(V), however, shall in no event exceed 183 days. The related purchaser does not have to conduct business outside the United States in order to be eligible to use the interest-free period of this paragraph (a)(1)(iii)(E). The interest-free period under this paragraph (a)(1)(iii)(E) shall not apply to intercompany trade receivables attributable to property which is manufactured, produced, or constructed (within the meaning of §1.954-3(a)(4)) by the related purchaser. For purposes of this paragraph (a)(1)(iii)(E) a product group includes all products within the same three-digit Standard Industrial Classification (SIC) Code (as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.)

(*2*) *Average collection period.* An average collection period for purposes of this paragraph (a)(1)(iii)(E) is determined as follows:

(*i*) *Step 1.* Determine total sales (less returns and allowances) by the related purchaser in the product group to unrelated persons located in the same foreign country during the related purchaser's last taxable year ending on or before the first day of the related seller's taxable year in which the intercompany trade receivable arises.

(*ii*) *Step 2.* Determine the related purchaser's average month-end accounts receivable balance with respect to sales described in paragraph (a)(1)(iii)(E)(*2*)(*i*) for the related purchaser's last taxable year ending on or before the first day of the related seller's taxable year in which the intercompany trade receivable arises.

(*iii*) *Step 3.* Compute a receivables turnover rate by dividing the total sales amount described in subdivision (*i*) of this paragraph by the average receivables balance described in subdivision (*ii*) of this paragraph.

(*iv*) *Step 4.* Divide the receivables turnover rate determined under subdivision (*iii*) of this paragraph into 365, and round the result to the nearest whole number to determine the number of days in the average collection period.

If the related purchaser makes sales in more than one foreign country, or sells property in more than one product group in any foreign country, separate computations of an average collection period, by product group within each country, are required. If the related purchaser resells fungible property in more than one foreign country and the intercompany trade receivables arising from the related party purchase of such fungible property cannot reasonably be identified with resales in particular foreign countries, then solely for the purpose of assigning an interest-free period to such intercompany trade receivables under this paragraph (a)(1)(iii)(E), an amount of each such intercompany trade receivable shall be treated as allocable to a particular foreign country in the same proportion that the related purchaser's sales of such fungible property in such foreign country during the period described in paragraph (a)(1)(iii)(E)(*2*)(*i*) bears to the related purchaser's sales of all such fungible property in all such foreign countries during such period. An interest-free period under this paragraph (a)(1)(iii)(E) shall not apply to any intercompany trade receivables arising in a taxable year of the related seller if the related purchaser made no sales described in paragraph (a)(1)(iii)(E)(*2*)(*i*) from which the appropriate interest-free period may be determined.

(*3*) *Illustration.* The interest-free period provided under paragraph (a)(1)(iii)(E) of this section may be illustrated by the following example:

Example—(i) *Facts.* X and Y use the calendar year as the taxable year and are members of the same group of controlled entities within the meaning of section 482. For Y's 1988 calendar taxable year X and Y intend to use the interest-free period determined under this paragraph (a)(1)(iii)(E) for intercompany trade receivables attributable to X's purchases of certain products from Y for resale by X in the ordinary course of business to unrelated persons in country Z. For its 1987 calendar taxable year all of X's sales in country Z were of products within a single product group based upon a three-digit SIC code, were not manufactured, produced, or constructed (within the meaning of §1.954–3(a)(4)) by X, and were sold in the ordinary course of X's trade or business to unrelated persons located only in country Z. These sales and the month-end accounts receivable balances (for such sales and for such sales uncollected from prior months) are as follows:

Month	*Sales*	*Accounts Receivable*
January, 1987	$500,000	$2,835,850
February	600,000	2,840,300
March	450,000	2,850,670
April	550,000	2,825,700
May	650,000	2,809,360
June	525,000	2,803,200
July	400,000	2,825,850
August	425,000	2,796,240
September	475,000	2,839,390
October	525,000	2,650,550
November	450,000	2,775,450
December, 1987	650,000	2,812,600
TOTALS	$6,200,000	$33,665,160

(ii) *Average collection period.* X's total sales within the same product group to unrelated persons within country Z for the period are $6,200,000. The average receivables balance for the period is $2,805,430 ($ 33,665,160/12). The average collection period in whole days is determined as follows:

$$\text{Receivables Turnover Rate} = \frac{\$6,200,000}{\$2,805,430} = 2.21$$

$$\text{Average Collection Period} = \frac{365}{2.21} = 165.16 \text{ days,}$$

rounded to the nearest whole day = 165 days.

(iii) *Interest-free period.* Accordingly, for intercompany trade receivables incurred by X during Y's 1988 calendar taxable year attributable to the purchase of property from Y for resale to unrelated persons located in country Z and included in the product group, X may use an interest-free period of 175 days (165 days in the average collection period plus 10 days, but not in excess of a maximum of 183 days). All other intercompany trade receivables incurred by X are subject to the interest-free periods described in paragraphs (a)(1)(iii)(B), (C), or (D), whichever are applicable. If X makes sales in other foreign countries in addition to country Z or makes sales of property in more than one product group in any foreign country, separate computations of X's average collection period, by product group within each country, are required in order for X and Y to determine an interest-free period for such product groups in such foreign countries under this paragraph (a)(1)(iii)(E).

(iv) *Payment; book entries.* (A) Except as otherwise provided in this paragraph (a)(1)(iv), in determining the period of time for which an amount owed by one member of the group to another member is outstanding, payments or other credits to an account are considered to be applied against the earliest amount outstanding, that is, payments or credits are applied against amounts in a first-in, first-out (FIFO) order. Thus, tracing payments to individual intercompany trade receivables is generally not required in order to determine whether a particular intercompany trade receivable has been paid within the applicable interest-free period determined under paragraph (a)(1)(iii). The application of this paragraph (a)(1)(iv)(A) may be illustrated by the following example:

Example—(*i*) *Facts.* X and Y are members of a group of controlled entities within the meaning of section 482. Assume that the balance of intercompany trade receivables owed by X to Y on June 1 is $100, and that all of the $100 balance represents amounts incurred by X to Y during the month of May. During the month of June X incurs an additional $200 of intercompany trade receivables to Y. Assume that on July 15, $60 is properly credited against X's intercompany account to Y, and that $240 is properly credited against the intercompany account on August 31. Assume that under paragraph (a)(1)(iii)(B) of this section interest must be charged on X's intercompany trade receivables to Y beginning with the first day of the third calendar month following the month the intercompany trade receivables arise, and that no alternative interest-free period applies. Thus, the interest-free period for intercompany trade receivables incurred during the month of May ends on July 31, and the interest-free period for intercompany trade receivables incurred during the month of June ends on August 31.

(*ii*) *Application of payments.* Using a FIFO payment order, the aggregate payments of $300 are applied first to the opening June balance, and then to the additional amounts incurred during the month of June. With respect to X's June opening balance of $100, no interest is required to be accrued on $60 of such balance paid by X on July 15, because such portion was paid within its interest-free period. Interest for 31 days, from August 1 to August 31 inclusive, is required to be accrued on the $40 portion of the opening balance not paid until August 31. No interest is required to be accrued on the $200 of intercompany trade receivables X incurred to Y during June because the $240 credited on August 31, after eliminating the $40 of indebtedness remaining from periods before June, also eliminated the $200 incurred by X during June prior to the end of the interest-free period for that amount. The amount of interest incurred by X to Y on the $40 amount during August creates bona fide indebtedness between controlled entities and is subject to the provisions of paragraph (a)(1)(iii)(A) of this section without regard to any of the exceptions contained in paragraphs (a)(1)(iii)(B) through (E).

(B) Notwithstanding the first-in, first-out payment application rule described in paragraph (a)(1)(iv)(A) of this section, the taxpayer may apply payments or credits against amounts owed in some other order on its books in accordance with an agreement or understanding of the related parties if the taxpayer can demonstrate that either it or others in its industry, as a regular trade practice, enter into such agreements or understandings in the case of similar balances with unrelated parties.

(2) *Arm's length interest rate*—(i) *In general.* For purposes of section 482 and paragraph (a) of this section, an arm's length rate of interest shall be a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. All relevant factors shall be considered, including the principal amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties.

(ii) *Funds obtained at situs of borrower.* Notwithstanding the other provisions of paragraph (a)(2) of this section, if the loan or advance represents the proceeds of a loan obtained by the lender at the situs of the borrower, the arm's length rate for any taxable year shall be equal to the rate actually paid by the lender increased by an amount which reflects the costs or deductions incurred by the lender in borrowing such amounts and making such loans, unless the taxpayer establishes a more appropriate rate under the standards set forth in paragraph (a)(2)(i) of this section.

(iii) *Safe haven interest rates for certain loans and advances made after May 8, 1986*—(A) *Applicability*—(*1*) *General rule.* Except as otherwise provided in paragraph (a)(2) of this section, paragraph (a)(2)(iii)(B) applies with respect to the rate of interest charged and to the amount of interest paid or accrued in any taxable year—

(*i*) Under a term loan or advance between members of a group of controlled entities where (except as provided in paragraph (a)(2)(iii)(A)(*2*)(*ii*)) the loan or advance is entered into after May 8, 1986, and

(*ii*) After May 8, 1986 under a demand loan or advance between such controlled entities.

(*2*) Grandfather rule for existing loans. The safe haven rates prescribed in paragraph (a)(2)(iii)(B) of this section shall not apply, and the safe haven rates prescribed in 26 CFR §1.482-2(a)(2)(iii) (revised as of April 1, 1985) shall apply to—

(i) Term loans or advances made before May 9, 1986, and

(ii) Term loans or advances made before August 7, 1986, pursuant to a binding written contract entered into before May 9, 1986.

(B) *Safe haven interest rate based on applicable Federal rate.* Except as otherwise provided in this paragraph (a)(2), in the case of a loan or advance between members of a group of controlled entities, an arm's length rate of interest referred to in paragraph (a)(2)(i) of this section shall be for purposes of Chapter 1 of the Code—

(*1*) The rate of interest actually charged if that rate is—

(i) Not less than 100 percent of the applicable Federal rate (the "lower limit"), and

(ii) Not greater than 130 percent of the applicable Federal rate (the "upper limit"), or

(*2*) If either no interest is charged or if the rate of interest charged is less than the lower limit, then an arm's length rate of interest shall be equal to the lower limit, compounded semiannually, or

(*3*) If the rate of interest charged is greater than the upper limit, then an arm's length rate of interest shall be equal to the upper limit, compounded semiannually, unless the taxpayer establishes a more appropriate compound rate of interest under paragraph (a)(2)(i) of this section. However, if the compound rate of interest actually charged is greater than the upper limit and less than the rate determined under paragraph (a)(2)(i) of this section, or if the compound rate actually charged is less than the lower limit and greater than the rate determined under paragraph (a)(2)(i), then the compound rate actually charged shall be deemed to be an arm's length rate under paragraph (a)(2)(i). In the case of any sale-leaseback described in section 1274(e), the lower limit shall be 110 percent of the applicable Federal rate, compounded semiannually.

(C) *Applicable Federal rate.* For purposes of paragraph (a)(2)(iii)(B) of this section, the term "applicable Federal rate" means, in the case of a loan or advance to which this section applies and having a term of—

(*1*) Not over 3 years, the Federal short-term rate,

(*2*) Over 3 years but not over 9 years, the Federal mid-term rate, or

(*3*) Over 9 years, the Federal long-term rate, as determined under section 1274(d) in effect on the date such loan or advance is made. In the case of any sale or exchange between controlled entities, the lower limit shall be the lowest of the applicable Federal rates in effect for any month in the 3-calendar-month period ending with the first calendar month in which there is a binding written contract in effect for such sale or exchange (the "lowest 3-month rate", as defined in section 1274(d)(2)). In the case of a demand loan or advance to which this section applies, the "applicable Federal rate" means the Federal short-term rate determined under section 1274(d) (determined without regard to the lowest 3-month short term rate determined under section 1274(d)(2)) in effect for each day on which any amount of such loan or advance (including unpaid accrued interest determined under paragraph (a)(2) of this section) is outstanding.

(D) *Lender in business of making loans.* If the lender in a loan or advance transaction to which paragraph (a)(2) of this section applies is regularly engaged in the trade or business or making loans or advances to unrelated parties, the safe haven rates prescribed in paragraph (a)(2)(iii)(B) shall not apply, and the arm's length interest rate to be used shall be determined under the standards described in paragraph (a)(2)(i), including reference to the interest rates charged in such trade or business by the lender on loans or advances of a similar type made to unrelated parties at and about the time the loan or advance to which paragraph (a)(2) of this section applies was made.

(E) *Foreign currency loans.* The safe haven interest rates prescribed in paragraph (a)(2)(iii)(B) of this section do not apply to any loan or advance the principal or interest of which is expressed in a currency other than U.S. dollars.

(3) *Coordination with interest adjustments required under certain other Code sections.* If the stated rate of interest on the stated principal amount of a loan or advance between controlled entities is subject to adjustment under section 482 and is also subject to adjustment under any other section of the Code (for example, section 467, 483, 1274 or 7872), section 482 and paragraph (a) of this section may be applied to such loan or advance in addition to such other Code section. After the enactment of the Tax Reform Act of 1984, Pub. L. 96-369, and the enactment of Pub. L. 99-121, such other Code sections include sections 467, 483, 1274 and 7872. The order in which the different provisions shall be applied is as follows:

(i) First, the substance of the transaction shall be determined; for this purpose, all the relevant facts and circumstances shall be considered and any law or rule of law (assignment of income, step transaction, etc.) may apply. Only the rate of interest with respect to the stated principal amount of the bona fide indebtedness (within the meaning of paragraph (a)(1) of this section), if any, shall be subject to adjustment under section 482, paragraph (a) of this section, and any other Code section.

(ii) Second, the other Code section shall be applied to the loan or advance to determine whether any amount other than stated interest is to be treated as interest, and if so, to determine such amount according to the provisions of such other Code section.

(iii) Third, whether or not the other Code section applies to adjust the amounts treated as interest under such loan or advance, section 482 and paragraph (a) of this section may then be applied by the district director to determine whether the rate of interest charged on the loan or advance, as adjusted by any other Code section, is greater or less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.

(iv) Fourth, section 482 and paragraphs (b) through (e) of this section, if applicable, may be applied by the district director to make any appropriate allocations, other than an interest rate adjustment, to reflect an arm's length transaction based upon the principal amount of the loan or advance and the interest rate as adjusted under paragraph (a)(3)(i), (ii) or (iii) of this section. For example, assume that two commonly controlled taxpayers enter into a deferred payment sale of tangible property and no interest is provided, and assume also that section 483 is applied to treat a portion of the stated sales price as interest, thereby reducing the stated sales price. If after this recharacterization of a portion of the stated sales price as interest, the recomputed sales price does not reflect an arm's length sales price under the principles of paragraph (e) of this section, the district director may make other appropriate allocations (other than an interest rate adjustment) to reflect an arm's length sales price.

(4) *Examples.* The principles of paragraph (a)(3) of this section may be illustrated by the following examples:

Example (1). An individual, A, transfers $20,000 to a corporation controlled by A in exchange for the corporation's note which bears adequate stated interest. The district director recharacterizes the transaction as a contribution to the capital of the corporation in exchange for preferred stock. Under paragraph (a)(3)(i) of this section, section 1.482-2(a) does not apply to the transaction because there is no bona fide indebtedness.

Example (2). B, an individual, is an employee of Z corporation, and is also the controlling shareholder of Z. Z makes a term loan of $15,000 to B at a rate of interest that is less than the applicable Federal rate. In this instance the other operative Code section is section 7872. Under section 7872(b), the difference between the amount loaned and the present value of all payments due under the loan using a discount rate equal to 100 percent of the applicable Federal rate is treated as an amount of cash transferred from the corporation to B and the loan is treated as having original issue discount equal to such amount. Under paragraph (a)(3)(iii) of this section, section 482 and paragraph (a) of this section may also be applied by the district director to determine if the rate of interest charged on this $15,000 loan (100 percent of the AFR, compounded semiannually, as adjusted by section 7872) is an arm's length rate of interest. Because the rate of interest on the loan, as adjusted by section 7872, is within the safe haven range of 100–130 percent of the AFR, compounded semiannually, no further interest rate adjustments under section 482 and paragraph (a) of this section will be made to this loan.

Example (3). The facts are the same as in example (2) except that the amount lent by Z to B is $9,000, and that amount is the aggregate outstanding amount of loans between Z and B. Under the $10,000 *de minimis* exception of section 7872(c)(3), no adjustment for interest will be made to this $9,000 loan under section 7872. Under paragraph (a)(3)(iii) of this section, the district director may apply section 482 and paragraph (a) of this section to this $9,000 loan to determine whether the rate of interest charged is less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.

Example (4). X and Y are commonly controlled taxpayers. At a time when the applicable Federal rate is 12 percent, compounded semiannually, X sells property to Y in exchange for a note with a stated rate of interest of 18 percent, compounded semiannually. Assume that the other applicable Code section to the transaction is section 483. Section 483 does not apply to this transaction because, under section 483(d), there is no total unstated interest under the contract using the test rate of interest equal to 100 percent of the applicable Federal rate. Under paragraph (a)(3)(iii) of this section, section 482 and paragraph (a) of this section may be applied by the district director to determine whether the rate of interest under the note is excessive, that is, to determine whether the 18 percent stated interest rate under the note exceeds an arm's length rate of interest.

Example (5). Assume that A and B are commonly controlled taxpayers and that the applicable Federal rate is 10 percent, compounded semiannually. On June 30, 1986, A sells property to B and receives in exchange B's purchase-money note in the amount of $2,000,000. The stated interest rate on the note is 9%, compounded semiannually, and the stated redemption price at maturity on the note is $2,000,000. Assume that the other applicable Code section to this transaction is section 1274. As provided in section 1274(a) and (b), the discount rate for purposes of section 1274 will be nine percent, compounded semiannually, because the stated principal amount of B's note does not exceed $2,800,000. Section 1274 does not apply to this transaction because there is adequate stated interest on the debt instrument using a discount rate equal to 9%, compounded semiannually, and the stated redemption price at maturity does not exceed the stated principal amount. Under paragraph (a)(3)(iii) of this section, the district director may apply section 482 and paragraph (a) of this section to this $2,000,000 note to determine whether the 9% rate of interest charged is less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.

* * * * *

(c) *Use of tangible property* ***

(2) *Arm's length charge*—(i) *In general.* For purposes of paragraph (c) of this section, an arm's length rental charge shall be the amount of rent which was charged, or would have been charged for the use of the same or similar property, during the time it was in use, in independent transactions with or between unrelated parties under similar circumstances considering the period and location of the use, the owner's investment in the property or rent paid for the property, expenses of maintaining the property, the type of property involved, its condition, and all other relevant facts.

(ii) *Safe haven rental charge.* See 26 CFR §1.482-2(c)(2)(ii) (revised as of April 1, 1985), for the determination of safe haven rental charges in the case of certain leases entered into before May 9, 1986, and for leases entered into before August 7, 1986, pursuant to a binding written contract entered into before May 9, 1986.

(iii) *Subleases.* (A) Except as provided in paragraph (c)(2)(iii)(B) of this section, where possession, use, or occupancy of tangible property, which is leased by the owner (lessee) from an unrelated party is transferred by sublease or other arrangement to the user, an arm's length rental charge shall be considered to be equal to all the deductions claimed by the owner (lessee) which are attributable to the property for the period such property is used by the user. Where only a portion of such property was transferred, any allocations shall be made with reference to the portion transferred. The deductions to be considered include the rent paid or accrued by the owner (lessee) during the period of use and all other deductions directly and indirectly connected with the property paid or accrued by the owner (lessee) during such period.

Such deductions include deductions for maintenance and repair, utilities, management and other similar deductions.

(B) The provisions of paragraph (c)(2)(iii)(A) of this section shall not apply if either—

(*1*) The taxpayer establishes a more appropriate rental charge under the general rule set forth in paragraph (c)(2)(i) of this section, or

(*2*) During the taxable year, the owner (lessee) or the user was regularly engaged in the trade or business of renting property of the same general type as the property in question to unrelated persons.

* * * * *

Par. 3. Paragraph (b)(12) of §1.7872-5T is revised to read as follows:

§1.7872-5T. Exempted loans.

* * * * *

(b) *List of exemptions.* ***

(12) Indebtedness subject to section 482, but such indebtedness is exempt from the application of section 7872 only during the interest-free period, if any, determined under §1.482-2(a)(1)(iii) with respect to intercompany trade receivables described in §1.482-2(a)(1)(ii)(A)(*ii*). See also §1.482-2(a)(3);

* * * * *

Michael J. Murphy,
Acting Commissioner of Internal Revenue.

Approved May 4, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 20, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 23, 1988, 53 F.R. 18276)

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1988. See Rev. Rul. 88-1, page 307.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1988. See Rev. Rul. 88-9, page 307.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 1988. See Rev. Rul. 88-15, page 308.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1988. See Rev. Rul. 88-22, page 309.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 1988. See Rev. Rul. 88-28, page 310.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 1988. See Rev. Rul. 88-44, page 312.

Subchapter G.—Corporations Used to Avoid Income Tax on Shareholders
Part II.—Personal Holding Companies

Section 541.—Imposition of Personal Holding Company Tax

26 CFR 1.541-1: imposition of tax.
(Also Sections 561, 852, 4982; 1.561-1, 1.852-1.)

Personal holding company and regulated investment company; liability for tax. A regulated investment company that is also a personal holding company is liable for tax under both sections 541 and 852(b)(1) of the Code on its retained income.

Rev. Rul. 88-41

ISSUE

If a regulated investment company that is also a personal holding company retains income, and thus has investment company taxable income and undistributed personal holding company income, is the company liable for tax under both sections 541 and 852(b)(1) of the Internal Revenue Code?

FACTS

X is a regulated investment company (RIC) within the meaning of section 851 of the Code. *X* is also a personal holding company within the meaning of section 542(a). (RICs are not included among the exceptions from the definition "personal holding company" provided in section 542(c)). *X* files returns on a calendar year basis.

In its tax year ending December 31, 1988, *X* has taxable income of 100*x* dollars. That 100*x* dollars is also personal holding company income within the meaning of section 543 of the Code.

X distributes 90*x* dollars (90 percent) of its 100*x* dollars taxable income and, pursuant to sections 561 and 852(b)(2)(D) of the Code, is allowed a dividends paid deduction of 90*x* dollars for the distribution. This distribution fulfills the requirements of section 852(a). *X* retains the remaining 10*x* dollars of its taxable income. *X* has no adjustments to its 100*x* dollars of taxable income of a personal holding company except the dividends paid deduction of 90*x* dollars and the deduction allowable under section 545(b)(1) for certain federal income taxes.

LAW AND ANALYSIS

Section 852(b)(1) of the Code, as amended by section 1071(a)(2) of the Tax Reform Act of 1984, 1984-3 (Vol. 1) C.B. 557, and section 1878(j)(2) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 822, provides that there is imposed for each taxable year upon the investment company taxable income of every RIC a tax computed as provided in section 11, as though the investment company taxable income were the taxable income referred to in section 11.

Section 852(b)(1) further provides that, in the case of a RIC that is a personal holding company (as defined in section 542), the tax upon investment company taxable income shall be computed at the highest rate of tax specified in section 11(b). For tax years beginning on or after July 1, 1987, this rate is 34 percent.

Section 852(b)(2) of the Code defines investment company taxable income as the taxable income of the RIC with certain adjustments, including the deduction for dividends paid (as defined in section 561) but computed without regard to capital gain dividends and exempt-interest dividends.

In this situation, *X* has 100*x* dollars of taxable income reduced by 90*x* dollars for its dividends paid deduction, leaving investment company taxable income of 10*x* dollars. Under section 852(b)(1) of the Code, *X* must pay tax on this undistributed income because it is investment company taxable income. Because *X* is a RIC that is also a personal holding company, that tax is computed at the highest corporate rate under section 11(b). The 34 percent rate of tax is applied to the retained investment company taxable income to arrive at a RIC tax of 3.4*x* dollars in 1988.

Section 541 of the Code provides that in addition to the other taxes imposed by chapter 1, there is imposed for each tax year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to 28 percent of the undistributed personal holding company income.

Section 545(a) of the Code provides that undistributed personal holding company income means the taxable income of a personal holding company less certain adjustments and less the dividends paid deduction as defined in section 561.

Section 545(b)(1) of the Code provides that one of the adjustments allowed by section 545(a) is a deduction for federal income taxes accrued during the tax year, other than the accumulated earnings tax imposed by section 531 and the personal holding company tax imposed by section 541. Thus, in computing the personal holding company tax of *X*, a deduction is allowed for amounts accrued for tax on its investment company taxable income.

For 1988, *X* has 100*x* dollars of taxable income reduced by 90*x* dollars for its dividends paid deduction and 3.4*x* dollars for tax accrued on its investment company taxable income, leaving 6.6*x* dollars of undistributed personal holding company income. The 28 percent rate of tax is applied to this amount to arrive at a personal holding company tax of 1.848*x* dollars.

Thus, the effective rate of tax in 1988 on *X*'s retained income of 10*x* dollars is 52.48 percent (3.4*x* dollars on its investment company taxable income and 1.848*x* dollars on its undistributed personal holding company income).

X may also be subject to the excise tax on undistributed income of regulated investment companies provided for in section 4982 of the Code.

HOLDING

X must pay tax under section 852(b)(1) of the Code on the 10*x* dollars investment company taxable income and under section 541 on the portion of the 10*x* dollars that is also undistributed personal holding company income.

Part IV.—Deduction for Dividends Paid

Section 561.—Definition of Deduction For Dividends Paid

26 CFR 1.561-1: Deduction for dividends paid.

If a regulated investment company that is also a personal holding company retains income, and thus has investment company taxable income and undistributed personal holding company income, is the company liable for tax under both sections 541 and 852(b)(1) of the Code? See Rev. Rul. 88-41, page 253.

Section 565.—Consent Dividends

26 CFR 1.565-1: General rule.

T.D. 8166

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; PART 602.—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Consent Dividends

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary Regulations.

SUMMARY: This document contains temporary regulations that amend the Income Tax Regulations under the consent dividend provisions of section 565 of the Internal Revenue Code of 1986. A review of the legislative history of section 565 has prompted a clarification of certain provisions of the regulations under section 565. The amendments to the regulations will provide the public with the new guidance needed to comply with section 565. The text of these temporary regulations also serves as the text of the proposed regulations *** [page 920, this Bulletin].

DATE: These regulations, as well as the deletions to the existing final regulations, are effective for tax years ending after December 15, 1987.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains temporary regulations that amend the Income Tax Regulations (26 CFR Part 1) under section 565 of the Internal Revenue Code of 1986 to clarify the scope of the consent dividend provisions of the Code.

NEED FOR TEMPORARY REGULATIONS

The proper application of section 565 is dependent upon the Internal Revenue Service providing detailed specifications of the manner in which the requirements of the statute will be administered. As a result of a review of section 565, it has been determined that it is necessary to clarify the regulations under section 565. Because of the need for immediate guidance in this regard, the Internal Revenue Service has found it to be impractical to issue these temporary regulations either with notice and public comment procedure under section 553(b) of title 5 of the United States Code, or under the effective date limitation of section 553(d) of title 5.

LEGISLATIVE HISTORY OF CONSENT DIVIDEND PROVISIONS

The consent dividend provisions were enacted in 1938 as a relief measure against a then generally applicable tax on undistributed corporate profits. This tax formed a part of the basic corporate income tax. The consent dividend provisions were intended to apply equally as broadly as did the tax upon undistributed profits because the consent dividend provisions were intended to provide relief from that tax. The tax on undistributed profits had expired by the time the Internal Revenue Code of 1954 was enacted. The consent dividend provisions were retained in the 1954 Code as a relief measure for a corporation that was required to distribute its earnings but was prevented from distributing cash because of loan restrictions, insufficiency of liquid resources, or other reasons. However, the regulation under section 565 did not make clear that they apply only to corporations or other taxable entities required to distribute their earnings.

RESTRICTED APPLICABILITY OF CONSENT DIVIDEND PROVISIONS

Taxable entities required to distribute their earnings are corporations subject to the accumulated earnings tax, personal holding companies, foreign personal holding companies, regulated investment companies, and real estate investment trusts. The amendments to the regulations clarify that the consent dividend provisions apply only to these entities. These amendments do not affect those provisions of the temporary regulations under section 367 (sections 7.367(b)-9(f) and 7.367(b)-10(f)) which permit United States shareholders to increase their basis in foreign corporations involved in certain reorganizations and distributions by the amount of earnings and profits of lower-tier foreign corporations on the condition that an election is made to treat such earnings and profits as having been distributed as dividends through intervening corporations to the upper-tier foreign corporation. This procedure differs from a consent dividend election under section 565 in that the electing shareholder is not treated as having received a dividend, and the election is not made with respect to stock held directly by the electing shareholder. The basis adjustment under these provisions is therefore not a consent dividend under section 565, but it is made in accordance with a procedure that is similar in form to a consent dividend election under that section.

In addition, the Service understands that, in certain circumstances, members of affiliated groups filing consolidated returns have elected consent dividends under section 565, without regard to whether they are required to distribute earnings, for the purpose of preventing the application of §1.1502-32(g). Generally, where a subsidiary leaves a consolidated group, §1,1502-32(g) requires that the members of the group reduce the basis of any stock of the subsidiary that they own on the first day of the subsidiary's first separate return year by the amount of any basis increases in the stock under §1.1502-32 for all consolidated return years. For this purpose, a year in which a subsidiary is included in the consolidated return of another group is considered a separate return year (*e.g.*, a year where the member of the affiliated group owning the stock of the subsidiary is acquired by another affiliated group filing a consolidated return).

As noted above, a subsidiary cannot make a consent dividend unless it is a corporation subject to the accumulated earnings tax, a personal holding company, a foreign personal holding company, a regulated investment company, or a real estate investment trust. The Service is studying the feasibility of changes in the consolidated return regulations that would alleviate the application of the §1.1502-32(g) adjustment for those corporations that do not qualify under §1.565-1 to make a consent dividend. Among the changes being considered is an exception similar to the exceptions under present law (such as §1.1502-13(f)(2)) that eliminates some of the effects of deconsolidation in certain circumstances where a group is acquired by another group filing consolidated returns. Guidance will be provided to taxpayers with respect to this issue in sufficient time to meet their tax return filing requirements.

EXECUTIVE ORDER 12291, REGULATORY FLEXIBILITY ACT, AND PAPERWORK REDUCTION ACT

It has been determined that this temporary regulation is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The collection of information requirements contained in this regulation have been submitted to the Office of Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduction Act of 1980. These requirements have been approved by OMB under control number 1545-0043.

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Parts 1 and 602 are amended as follows:

INCOME TAX REGULATIONS (26 CFR PART 1)

Paragraph 1. The authority for Part 1 continues to read in part:

Authority: 26 CFR 7805. ***

Par. 2. Section 1.565-1 is hereby deleted.

Par. 3. The following new section is added immediately after §1.564-1.

§1.565-1T General rule (Temporary).

(a) *Consent dividends.* The dividends paid deduction, as defined in section 561, includes the consent dividends for the taxable year. A consent dividend is a hypothetical distribution (as distinguished from an actual distribution) made by:

(1) a corporation that has a reasonable basis to believe that it is subject to the accumulated earnings tax imposed in part I of subchapter G, chapter 1 of the Code, or

(2) a corporation described in part II (personal holding companies) or part III (foreign personal holding companies) of subchapter G or in part I (regulated investment companies) or part II (real estate investment trusts) of subchapter M, chapter 1 of the Code.

A consent dividend may be made by a corporation described in this paragraph to any person who owns consent stock on the last day of the taxable year of such corporation and who agrees to treat the hypothetical distribution as an actual dividend, subject to the limitations in section 565, §1.565-2T, and paragraph (c)(2) of this section, by filing a consent at the time and in the manner specified in paragraph (b) of this section.

(b) *Making and filing of consents.* (1) A consent shall be made on Form 972 in accordance with this section and the instructions on the form issued therewith. It may be made only by or on behalf of a person who was the actual owner on the last day of the corporation's taxable year of any class of consent stock, that is, the person who would have been required to include in gross income any dividends on such stock actually distributed on the last day of such year. Form 972 shall contain or be verified by a written declaration that is made under the penalties of perjury. In the consent such person must agree to include in gross income for his taxable year in which or with which the taxable year of the corporation ends a specific amount as a taxable dividend.

(2) See paragraph (c) of this section and §1.565-2T for the rules as to when all or a portion of the amount so specified will be disregarded for tax purposes.

(3) A consent may be filed at any time not later than the due date of the corporation's income tax return for the taxable year for which the dividends paid deduction is claimed. With such return, and not later than the due date thereof, the corporation must file Forms 972 duly executed by each consenting shareholder, and a return on Form 973 showing by classes the stock outstanding on the first and last days of the taxable year, the dividend rights of such stock, distributions made during the taxable year to shareholders, and giving all the other information required by the form. Form 973 shall contain or be verified by a written declaration that is made under the penalties of perjury.

(c) *Taxability of amounts specified in consents.* (1) The filing of a consent is irrevocable, and except as otherwise provided in section 565(b), §1.565-2T, and paragraph (c)(2) of this section, the full amount specified in a consent filed by a shareholder of a corporation described in paragraph (a) of this section shall be included in the gross income of the shareholder as a taxable dividend. Where the shareholder is taxable on a dividend only if received from sources within the United States, the amount specified in the consent of the shareholder shall be treated as a dividend from sources within the United States in the same manner as if the dividend had been paid in money to the shareholder on the last day of the corporation's taxable year. See paragraph (b) of this section relating to the making and filing of consents, and section 565(e) and §1.565-5T, with respect to the payment requirement in the case of nonresident aliens and foreign corporations.

(2) To the extent that the Commissioner determines that the corporation making a consent dividend is not a corporation described in paragraph (a) of this section, the amount specified in the consent is not a consent dividend and the amount specified in the consent will not be included in the gross income of the shareholder. In addition, where a corporation is described in paragraph (a)(1) but not paragraph (a)(2) of this section, to the extent that the Commissioner determines that the amount specified in a consent is larger than the amount of earnings subject to the accumulated earnings tax imposed by part I of subchapter G, such excess is not a consent dividend under paragraph (a) of this section and will not be included in the gross income of the shareholder.

(3) Except as provided in section 565(b), §1.565-2T and paragraph (c)(2) of this section, once a shareholder's consent is filed, the full amount specified in such consent must be included in the shareholder's gross income as a taxable dividend, and the ground upon which a deduction for consent dividends is denied the corporation does not affect the taxability of a shareholder whose consent has been filed for the amount specified in the consent. For example, although described in part I, II, or III of subchapter G, or part I or II of subchapter M, chapter I of the Code, the corporation's taxable income (as adjusted under section 535(b), 545(b), 556(b), 852(b)(2), or 857(b)(2), as appropriate) may be less than the total of the consent dividends.

(4) A shareholder who is a nonresident alien or a foreign corporation is taxable on the full amount of the consent dividend that otherwise qualifies under this section even though that payment has not been made as required by section 565(e) and §1.565-5T.

(5) Income of a foreign corporation is not subject to the tax on accumulated earnings under part I of subchapter G, chapter 1 of the Code except to the extent of U.S. source income, adjusted as permitted under section 535. See section 535(b) and (d) and §1.535-1(b). Therefore, foreign source earnings (other than those distributions subject to resourcing under section 535(d)) of a foreign corporation that is not described in paragraph (a)(2) of this section cannot qualify for consent dividend treatment. Accordingly, a consent dividend made by a foreign corporation described in paragraph (a)(1) of this section shall not be effective with respect to all of the corporation's earnings, but shall relate solely to earnings which would have been, in the absence of the consent dividend, subject to the accumulated earnings tax.

Par. 4. Section 1.565-2 is hereby deleted.

Par. 5. The following new section is added immediately after §1.565-1T.

§1.565-2T Limitations (Temporary).

(a) Amounts specified in consents filed by shareholders or other beneficial owners of a corporation described in §1.565-1T(a) are not treated as consent dividends to the extent that—

(1) They would constitute a preferential dividend; or

(2) They would not constitute a dividend (as defined in section 316),

if distributed in money to shareholders on the last day of the taxable year of the corporation. If any portion of any amount specified in a consent filed by a shareholder of a corporation described in the preceding sentence is not treated as a consent dividend under section 565(b) and this section, it is disregarded for all tax purposes. For example, it is not taxable to the consenting shareholder, and paragraph (c) of §1.565-1T is not applicable to this portion of the amount specified in the consent.

(b)(1) A preferential distribution is an actual distribution, or a consent distribution, or a combination of the two, which involves a preference to one or more shares of stock as compared with other shares of the same class or to one class of stock as compared with any other class of stock. See section 562(c) and §1.562-2.

(2) The application of section 565(b)(1) may be illustrated by the following examples:

Example (1). The X Corporation, a personal holding company, which makes its income tax returns on the calendar year basis, has 200 shares of stock outstanding, owned by A and B in equal amounts. On December 15, 1987, the corporation distributes $600 to B and $100 to A. As a part of the same distribution, A executes a consent to include $500 in his gross income as a taxable dividend although such amount is not distributed to him. The X Corporation, assuming the other requirements of section 565 have been complied with, is entitled to a consent dividends deduction of $500. Although the consent dividend is deemed to have been paid on December 31, 1987, the last day of the taxable year of the corporation, they constitute a single nonpreferential distribution of $1200.

Example (2). The Y corporation, a personal holding company, which makes its income tax returns on the calendar year basis, has one class of consent stock outstanding, owned in equal amounts by A, B, and C. On December 15, 1987, the corporation makes a distribution in cash of $5,000 each to A and B, and $3,000 to C. The distribution is preferential. If A and B each receive a distribution in cash of $5,000 and C consents to include $3,000 in gross income as a taxable dividend, the combined actual and consent distribution is preferential. Similarly, if no one receives a distribution in cash, but A and B each consents to include $5,000 as a taxable dividend in gross income and C agrees to include only $3,000, the consent distribution is preferential.

Example (3). The Z Corporation, which makes its income tax returns on the calendar year basis and is subject, for the taxable year in question, to the accumulated earnings tax, has only two classes of stock outstanding, each class being consent stock and consisting of 500 shares. Class A, with a par value of $40 per share, is entitled to two-thirds of any distribution of earnings and profits. Class B, with a par value of $20 per share, is entitled to one-third of any distribution of earnings and profits. On December 15, 1987, there is distributed on the class B stock $2 per share, or $1,000, and shareholders of the class A stock consent to include in gross income amounts equal to $2 per share, or $1,000. The distribution is preferential, inasmuch as the class B stock has received more than its pro rata share of the combined amounts of the actual distributions and the consent distributions.

(c) (1) An additional limitation under section 565(b) is that the amounts specified in consents which may be treated as consent dividends cannot exceed the amounts which would constitute a dividend (as defined in section 316) if the corporation had distributed the total specified amounts in money to shareholders on the last day of the taxable year of the corporation. If only a portion of such total would constitute a dividend, then only a corresponding portion of each specified amount is treated as a consent dividend.

(2) The application of section 565(b)(2) may be illustrated by the following example:

Example. The X Corporation, a personal holding company, which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, owned in equal amounts by A and B. It makes no distributions during the taxable year 1987. Its earnings and profits for the calendar year 1987 amount to $8,000, there being at the beginning of such year no accumulated earnings or profits. A and B execute proper consents to include $5,000 each in their gross income as a dividend received by them on December 31, 1987. The sum of the amounts specified in the consents executed by A and B is $10,000, but if $10,000 had actually been distributed by the X corporation on December 31, 1987, only $8,000 would have constituted a dividend under section 316(a). The amount which could be considered as consent dividends in computing the dividends paid deduction for purposes of the accumulated earnings tax is limited to $8,000, or $4,000 of the $5,000 specified in each consent. The remaining $1,000 in each consent is disregarded for all tax purposes. The amount which could be considered as consent dividends in computing the dividends paid deduction for purposes of the personal holding company tax is $10,000 (assuming that the undistributed personal holding company income, determined without regard to distributions under section 316(b)(2), is equal to at least that amount). In that event, A and B would each include $5,000 in gross income as a dividend received on December 31, 1987.

Par. 6. Section 1.565-3 is hereby deleted.

Par. 7. The following new section is added immediately after §1.565-2T.

§1.565-3T Effect of consent (Temporary).

(a) The amount of the consent dividend that is described in paragraph (a) of §1.565-1T shall be considered, for all purposes of the Code, as if it were distributed in money by the corporation to the shareholder on the last day of the taxable year of the corporation, received by the shareholder on such day, and immediately contributed by the shareholder as paid-in capital to the corporation on such day. Thus, the amount of the consent dividend will be treated by the shareholder as a dividend. The shareholder will be entitled to the dividends received deduction under section 243 or 245 with respect to such consent dividend. The basis of the shareholder's consent stock in a corporation will be increased by the amount thus treated in his hands as a dividend which he is considered as having contributed to the corporation as paid-in capital. The amount of the current dividend will also be treated as a dividend received from sources within the United States in the same manner as if the dividend has been paid in money to the shareholders. Among other effects of the consent dividend, the earnings and profits of the corporation will be decreased by the amount of the consent dividends. Moreover, if the shareholder is a corporation, its accumulated earnings and profits will be increased by the amount of the consent dividend with respect to which it makes a consent.

(b) The application of section 565(c) to a corporate shareholder may be illustrated by the following example:

Example. Corporation A, a personal holding company and a calendar year taxpayer, has one shareholder, individual B, whose consent to include $10,000 in his gross income for the calendar year 1987 has been timely filed. A has $8,000 of earnings and profits in 1987 and had no accumulated earnings and profits at the beginning of 1987. A has $10,000 of undistributed personal holding company income (determined without regard to distributions under section 316(b)(2)) for 1987. B must include $10,000 in his gross income as a taxable income and is treated as having immediately contributed $10,000 to A as paid-in capital. See section 316(b)(2).

Par. 8. Section 1.565-5 is hereby deleted.

Par. 9. The following new section is added immediately after §1.565-4.

§1.565-5T Nonresident aliens and foreign corporations (Temporary).

In the event that any consent filed by a corporation that is described in paragraph (a) of §1.565-1T is made by a shareholder to whom the payment of a dividend in cash on the last day of the taxable year of the corporation would have made it necessary for the corporation to deduct and withhold any amount as a tax under section 1441 or section 1442, such consent, when filed by the corporation, must be accompanied by payment of the amount which would have been required to be deducted and withheld if the amount specified in such consent had, on the last day of the corporation's taxable year, been paid to the shareholder in cash as a dividend. Such payment must be in one of the following forms:

(a) Cash;

(b) United States postal money order;

(c) Certified check drawn on a domestic bank, provided that the law of the place where the bank is located does not permit the certification to be rescinded prior to presentation;

(d) A cashier's check of a domestic bank, or

(e) A draft on a domestic bank or a foreign bank maintaining a United States agency or branch and payable in United States funds.

The amount of such payment shall be credited against the tax imposed on the shareholder.

Par. 10. Section 1.565-6 is hereby deleted.

Par. 11. The following new section is added immediately after §1.565-5T.

§1.565-6T Definitions (Temporary).

(a) *Consent stock.* (1) The term "consent stock" includes what is generally known as common stock. It also includes participating preferred stock, the participation rights of which are unlimited.

(2) The definition of consent stock may be illustrated by the following example:

Example. If in the case of the X Corporation, a personal holding company, there is only one class of stock outstanding, it would all be consent stock. If, on the other hand, there were two classes of stock, class A and class B, and class A was entitled to 6 percent before any distribution could be made on class B, but class B was entitled to everything distributed after class A had received its 6 percent, only class B stock would be consent stock. Similarly, if class A, after receiving its 6 percent, was to participate equally or in some fixed proportion with class B until it had received a second 6 percent, after which class B alone was entitled to any further distributions, only class B stock would be consent stock. The same result would follow if the order of preferences were class A 6 percent, then class B 6 percent, then class A a second 6 percent, either alone or in conjunction with class B, then class B the remainder. If, however, class A stock is entitled to ultimate participation without limit as to amount, then it, too, may be consent stock. For example, if class A is to receive 3 percent and then share equally or in some fixed proportion with class B in the remainder of the earnings or profits distributed, both class A stock and class B stock are consent stock.

(b) *Preferred dividends.* (1) The term "preferred dividends" includes all fixed amounts (whether determined by percentage of par value, a stated return expressed in a certain number of dollars per share, or otherwise) the distribution of which on any class of stock is a condition precedent to a further distribution of earnings or profits (not including a distribution in partial or complete liquidation). A distribution, though expressed in terms of a fixed amount, is not a preferred dividend, however, unless it is preferred over a subsequent distribution within the taxable year upon some class or classes of stock other than one on which it is payable.

(2) The definition of preferred dividends may be illustrated by the following example:

Example. If, in the case of the X Corporation, there are only two classes of stock outstanding, class A and class B, and class A is entitled to a distribution of 6 percent of par, after which the balance of the earnings and profits are distributable on class B exclusively, class A's 6 percent is a preferred dividend. If the order of preferences is class A $6 per share, class B $6 per share, then class A and class B in fixed proportions until class A receives $3 more per share, then class B the remainder, all of class A's $9 per share and $6 per share of the amount distributable on class B are preferred dividends. The amount which class B is entitled to receive in conjunction with the payment to class A of its last $3 per share is not a preferred dividend, because the payment of such amount is preferred over no subsequent distribution except one made on class B itself. Finally, if a distribution must be $6 on class A, $6 on class B, then on class A and class B share and share alike, the distribution on class A of $6 and the distribution on class B of $6 are both preferred dividends.

OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT (CFR PART 602)

Par. 12. The authority for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 13. Section 602.101(c) is amended by inserting in the appropriate place in the table:

"§1.565-1T . . . 1545-0043."
"§1.565-2T . . . 1545-0043."
"§1.565-3T . . . 1545-0043."
"§1.565-5T . . . 1545-0043."
"§1.565-6T . . . 1545-0043."

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved October 14, 1987.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on December 11, 1987, 9:13 a.m., and published in the issue of the Federal Register for December 15, 1987, 52 F.R. 47554)

Subchapter I.—Natural Resources
Part I.—Deductions

Section 612.—Basis For Cost Depletion

26 CFR 1.612-4: Charges to capital and to expense in case of oil and gas wells.

Whether costs incurred to drill expendable holes to determine the location and delineation of offshore hydrocarbon deposits are within the option to expense intangible drilling and development costs (IDC), pursuant to section 263(c) of the Code. See Rev. Rul. 88-10, page 112.

Subchapter K.—Partners and Partnerships
Part I.—Determination of Tax Liability

Section 702.—Income and Credits of Partner

26 CFR 1.702-1T: Temporary regulations on requirement to separately state meal, travel, and entertainment expenses.

T.D. 8182

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Requirement for Certain Partnerships and S Corporations to Separately State Meal, Travel, and Entertainment Expenses

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the requirement for certain partnerships or S corporations to separately state meal, travel, and entertainment expenses. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations *** [LR-29-87, page 927, this Bulletin].

DATE: The regulations are effective for taxable years beginning on or after January 1, 1987.

SUPPLEMENTARY INFORMATION:

Section 142 of the Tax Reform Act of 1986 (the Act) made significant changes to the rules for deducting meal, entertainment, and travel expenses. The Internal Revenue Service published Notice 87-23 in 1987-1 C.B. 467. The purpose of Notice 87-23 was to alert taxpayers to these changes. The Service published Notice 87-45 in 1987-1 C.B. 502. Notice 87-45 provided additional instructions to Form 1065 and Form 1120S concerning the treatment of expenses for meals, travel, and entertainment of certain 1986-87 fiscal year partnerships and S corporations.

In general, the changes made by the Act to the rules regarding deductions for meal, travel, and entertainment expenses are effective for taxable years beginning after December 31, 1986. In the case of a partnership or an S corporation, deductions for meals, travel, and entertainment expenses are reflected in the taxable income of a partner or shareholder for the taxable year with which or within which the taxable year of the partnership or S corporation ends. Under section 702(a)(7) of the Internal Revenue Code, in the case of a partnership, and section 1366(a)(1)(A), in the case of an S corporation, expenses that are subject to provisions of the Act are to be accounted for separately in certain years, since these items will affect the tax liability of partners and shareholders if separately stated in such years. For example, a partnership with a fiscal year ending June 30, 1987, should separately state meal and entertainment expenses paid or incurred during such taxable year (including amounts paid or incurred prior to January 1, 1987) and such amounts are subject to the new rules, such as the 80 percent limitation, with respect to partners with taxable years beginning on or after January 1, 1987. Accordingly, the changes made by the Act apply to expenses paid or incurred by partnerships or S corporations for taxable years ending after December 31, 1986, with respect to partners and S corporation shareholders whose taxable years begin on or after January 1, 1987.

However, because the application of the effective date provisions to partnerships and S corporations may impose substantial administrative burdens on taxpayers for expense paid or incurred prior to January 1, 1987, the temporary regulations do not apply to meal, travel, and entertainment expenses of partnerships and S corporations that are paid or incurred before January 1, 1987. Thus, the temporary regulations under sections 702(a)(7) and 1366(a)(1)(A) of the Code require partnerships and S corporations to separately state expenses paid or incurred after December 31, 1986, by partnerships or S corporations that have taxable years beginning before January 1, 1987, and ending with or within partners' or shareholders' taxable years beginning on or after January 1, 1987. In addition, with respect to skybox rentals (subject to provisions of the Act) a separate statement is required for rents paid or incurred after December 31, 1986, by partnerships or S corporations that have taxable years beginning before January 1, 1989, and ending with or within partners' or shareholders' taxable years beginning on or after January 1, 1987.

SPECIAL ANALYSES

No general notice of proposed rulemaking is required by 5 U.S.C. 553(b) for temporary regulations. Accordingly, the Regulatory Flexibility Act does not apply and no regulatory flexibility analysis is required for this rule. The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis therefore is not required.

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

Paragraph 1. The authority for Part 1 continues to read in part:

Authority: 26 U.S.C. 7805. ***

Par. 2. New §1.702-1T is added immediately after §1.702-1 to read as follows:

§1.702-1T Temporary regulations on requirement to separately state meal, travel, and entertainment expenses.

Each partner shall take into account separately his or her distributive share of meal, travel, and entertainment expenses paid or incurred after December 31, 1986, by partnerships that have taxable years beginning before January 1, 1987, and ending with or within partners' taxable years beginning on or after January 1, 1987. In addition, with respect to skybox rentals under section 274(l)(2), each partner shall take into account separately his or her distributive share of rents paid or incurred after December 31, 1986, by partnerships that have taxable years beginning before January 1, 1989, and ending with or within partners' taxable years beginning on or after January 1, 1987.

Par. 3. New §1.1366-1T is added immediately after §1.1361-1A to read as follows:

§1.1366-1T Temporary regulations on requirement to separately state meal, travel, and entertainment expenses.

Each shareholder shall take into account separately his or her pro rata share of meal, travel, and entertainment expenses paid or incurred after December 31, 1986, by S corporations that have taxable years beginning before January 1, 1987, and ending with or within shareholders' taxable years beginning on or after January 1, 1987. In addition, with respect to skybox rentals under section 274(l)(2), each shareholder shall take into account separately his or her pro rata share of rents paid or incurred after December 31, 1986, by S corporations that have taxable years beginning before January 1, 1989, and ending with or within shareholders' taxable years beginning on or after January 1, 1987.

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason it is found impracticable to issue it with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved February 9, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 1, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 2, 1988, 53 F.R. 6602).

Section 706.—Taxable Years of Partner and Partnership

26 CFR 1.706-1T: Taxable years of certain partnerships. (Temporary).

T.D. 8169

TITLE 26.—INTERNAL REVENUE—CHAPTER 1,SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Taxable Years of Certain Partnerships

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document provides temporary regulations relating to the appropriate taxable year for certain partnerships. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations *** [page 924, this Bulletin]. The temporary regulations reflect an amendment to section 706(b) of the Internal Revenue Code with respect to the taxable years of certain partnerships as made by section 806 of the Tax Reform Act of 1986 and provide guidance to partnerships with respect to the new provision.

DATES: The regulations contained in this document will be effective for partnership taxable years beginning after December 31, 1986.

SUPPLEMENTARY INFORMATION

BACKGROUND

Prior to its amendment by section 806 of the Tax Reform Act of 1986 (H.R. 3838, Pub. L. 99-514, "the Act", [1986-3 C.B. (Vol. 1) 1, 279], section 706(b) required a partnership adopting or changing a taxable year to use the same taxable year as the taxable year of all of its principal partners (or the calendar year, if all the partnership's principal partners did not have the same taxable year), unless the partnership established, to the satisfaction of the Secretary of the Treasury, a business purpose for selecting a different taxable year.

Section 706(b), as amended by section 806 of the Act, requires that any partnership (except where a business purpose for some other taxable year is established) must conform its taxable year to (a) the taxable year of one or more of its partners who have an aggregate interest in partnership profits and capital of greater than 50 percent, (b) if no taxable year is described in (a), the taxable year of all of its principal partners, or (c) if no taxable year is described in (a) or (b), the calendar year or such other year as may be prescribed by regulations.

This document, under the authority of section 706(b)(1)(B)(iii), prescribes rules for determining when the calendar year will not be an appropriate taxable year for the partnership and which year will be appropriate in such cases.

EXPLANATION OF PROVISIONS

Section 1.706-1T(a) generally provides that, if a partnership is unable to determine its taxable year by reference to the taxable year of its partners owning a majority interest in partnership profits and capital (as described in section 706(b)(1)(B)(i)) or by reference to the taxable year of all of its principal partners (as described in section 706(b)(1)(B)(ii)), its taxable year is the year that results in the least aggregate deferral of income to the partners. Deferral to each partner is measured in terms of months from the end of the partnership's taxable year forward to the end of the partner's taxable year. The taxable year that results in the least aggregate deferral of income to the partners is determined under §1.706-1T(a)(2) by comparing the deferral that would result to the partners if a particular partner's taxable year were the partnership's taxable year. Rules are also provided to minimize the number of changes in the partnership's taxable year under section 706 (b)(1)(B)(iii) where there would be a de minimis change in the aggregate deferral to the partners.

REGULATORY FLEXIBILITY ACT, EXECUTIVE ORDER 12291, AND PAPERWORK REDUCTION ACT OF 1980

No general notice of proposed rulemaking is required by 5 U.S.C. 553(b) for temporary regulations. Accordingly, the Regulatory Flexibility Act (5 U.S.C. Chapter 6) does not apply and no Regulatory Flexibility Analysis is required for this rule. The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. The reporting requirements added by this document have been submitted to the Office of Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduction Act of 1980. The reporting requirements have been approved by OMB under control number 1545-0099.

Adoption of amendments to the regulations

Accordingly, 26 CFR Parts 1 and 602 are amended as follows:

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. section 7805. *** Section 1.706-1T also issued under 26 U.S.C. 706(b).

Par. 2. A new §1.706-1T is added immediately following existing §1.706-1 to read as follows:

§1.706-1T Taxable years of certain partnerships (Temporary).

(a) *Taxable year determined by reference to the partners*—(1) *In general.* If for any taxable year a partnership's taxable year cannot be determined by reference to the taxable year of its partners owning a majority interest in partnership profits and capital (as described in section 706(b)(1)(B)(i)) or by reference to the taxable year of all its principal partners (as described in section 706(b)(1)(B)(ii)), then the partnership must determine its taxable year under section 706(b)(1)(B)(iii). Under section 706(b)(1)(B)(iii), the taxable year of the partnership, except as provided in paragraph (b) of this section, shall be the taxable year that results in the least aggregate deferral of income to the partners (as determined under paragraph (a)(2) of this section).

(2) *Taxable year that results in the least aggregate deferral of income.* The taxable year that results in the least aggregate deferral of income will be the taxable year of one or more of the partners in the partnership which will result in the least aggregate deferral of income to the partners. The aggregate deferral for a particular year is equal to the sum of the products determined by multiplying the month(s) of deferral for each partner that would be generated by that year and each partner's interest in partnership profits for that year. The partner's taxable year that produces the lowest sum when compared to the other partners' taxable years is the taxable year that results in the least aggregate deferral of income to the partners. If the calculation results in more than one taxable year qualifying as the taxable year with the least aggregate deferral, the partnership may select any one of those taxable years as its taxable year. However, if one of the qualifying taxable years is also the partnership's existing taxable year, the partnership must maintain its existing taxable

year. The determination of the taxable year that results in the least aggregate deferral of income shall generally be made as of the beginning of the partnership's current taxable year. The District Director, however, may determine that the first day of the current taxable year is not the appropriate testing day and require the use of some other day or period that will more accurately reflect the ownership of the partnership and thereby the actual aggregate deferral to the partners where the partners engage in a transaction that has as its principal purpose the avoidance of the principles of this section. Thus, for example, the preceding sentence would apply where there is a transfer of an interest in the partnership that results in a temporary transfer of that interest principally for purposes of qualifying for a specific taxable year under the principles of this section. For purposes of this section, deferral to each partner is measured in terms of months from the end of the partnership's taxable year forward to the end of the partner's taxable year.

(3) *Determination of the taxable year of a partner or partnership that uses a 52-53 week taxable year.* For purposes of the calculation described in paragraph (a)(2) of this section, the taxable year of a partner or partnership that uses a 52-53 week taxable year shall be the same year determined under the rules of section 441(f) and the regulations thereunder with respect to the inclusion of income by the partner or partnership.

(4) *Special de minimis rule.* If the taxable year that results in the least aggregate deferral produces an aggregate deferral that is less than .5 when compared to the aggregate deferral of the current taxable year, the partnerhip's current taxable year shall be treated as the taxable year with the least aggregate deferral. Thus, the partnership's will not be permitted to change its taxable year. However, this de minimis rule will not apply to the first taxable period beginning after December 31, 1986.

(b) *Business purpose.* A partnership may have a taxable year other than the year described in paragraph (a) of this section if it establishes, to the satisfaction of the Commissioner of Internal Revenue, a business purpose for such taxable year in accordance with and under the procedures established in §1.442-1(b)(1). For purposes of this paragraph (b), any deferral of income to partners shall not be treated as a business purpose.

(c) *Procedural requirements and effective date*—(1) *In general.* The change in accounting period required by paragraph (a) of this section shall be treated as initiated by the partnership and made with the consent of the Commissioner. To effect the change, a partnership must show that the requirements of this section are satisfied in a statement setting forth the computations required to establish the taxable year that results in the least aggregate deferral of income to the partners under paragraph (a) of this section. The partnership must attach the statement to the income tax return for the short period involved in the change and must indicate the following at the top of page 1 of the return: "FILED UNDER §1.706-1T."

(2) *Effective date*—(i) *In general.* Except as provided in paragraph (c)(2)(ii) of this section, the rules of this section are effective for partnership taxable years beginning after December 31, 1986.

(ii) *Special rule for first taxable year beginning after December 31, 1986.* A partnership otherwise required to change its accounting period for its first taxable year beginning after December 31, 1986 to a year resulting in the least aggregate deferral of income to its partners under paragraph (a) of this section, may, at its option, delay the application of the rules of that paragraph until its first taxable year beginning after December 31, 1987. In such a case, the partnership must conform its first taxable year beginning after December 31, 1986 to the calendar year and must apply the rules of paragraph (a) of this section to its first taxable year beginning after December 31, 1987. See §1.702-3T(a)(1) regarding the availability of a 4-year spread provision with respect to a partnership required to change its taxable year for its first taxable year beginning after December 31, 1986.

(iii) *Special eligibility for 4-year spread; years beginning after December 31, 1987.* Notwithstanding the provisions of §1.702-3T(a)(1) limiting the availability of the 4-year spread provisions to a partnership's first taxable year beginning after December 31, 1986, if—

(A) A partnership is required under section 706(b)(1)(B)(iii) and paragraph (a) of this section to change to a taxable year that results in the least aggregate deferral of income to the partners for a partnership's first taxable year beginning after December 31, 1987,

(B) The partnership did exercise its option, as provided in paragraph (c)(2)(ii) of this section, to delay the application of the rules of paragraph (a) of this section until the partnership's first taxable year beginning after December 31, 1987, and

(C) The partnership would have been required to change its accounting period under section 706(b)(1)(B)(iii) and paragraph (a) of this section for its first taxable year beginning after December 31, 1986, if paragraph (a) of this section had been applicable to such taxable year, the partners in the partnership will be eligible to utilize the 4-year spread provision provided in §1.702-3T (subject to the other requirements of that section) with respect to the partnership's change in accounting period required under section 706(b)(1)(B)(iii) and paragraph (a) of this section for the partnership's first taxable year beginning after December 31, 1987.

(d) *Examples.* The principles of this section may be illustrated by the following examples:

Example (1). Partnership P is on a fiscal year ending June 30. Partner A reports income on the fiscal year ending June 30 and Partner B reports income on the fiscal year ending July 31. A and B each have a 50 percent interest in partnership profits. For its taxable year beginning July 1, 1987, the partnership will be required to retain its taxable year since the fiscal year ending June 30 results in the least aggregate deferral of income to the partners. This determination is made as follows:

Test 6/30:	Year End	Interest in Partnership Profits	Months of Deferral for 6/30 Year End	Interest x Deferral
Partner A	6/30	.5	0	0
Partner B	7/31	.5	1	.5
Aggregate deferral				.5

Test 7/31:	Year End	Interest in Partnership Profits	Months of Deferral for 7/31 Year End	Interest x Deferral
Partner A	6/30	.5	11	5.5
Partner B	7/31	.5	0	0
Aggregate deferral				5.5

Example (2). The facts are the same as in *example (1)* except that A reports income on the calendar year and B reports on the fiscal year ending November 30. For the partnership's taxable year beginning July 1, 1987, the partnership is required to change its taxable year to a fiscal year ending November 30 because such year results in the least aggregate deferral of income to the partners. This determination is made as follows:

Test 12/31:	Year End	Interest in Partnership Profits	Months of Deferral for 12/31 Year End	Interest x Deferral
Partner A	12/31	.5	0	0
Partner B	11/30	.5	11	5.5
Aggregate deferral				5.5

Test 11/30:	Year End	Interest in Partnership Profits	Months of Deferral for 11/30 Year End	Interest x Deferral
Partner A	12/31	.5	1	.5
Partner B	11/30	.5	0	0
Aggregate deferral				.5

Example (3). The facts are the same as in *example (2)* except B reports income on the fiscal year ending June 30. For the partnership's taxable year beginning July 1, 1987, each partner's taxable year will result in identical aggregate deferral of income. If the partnership's current taxable year was neither a fiscal year ending June 30 nor the calendar year, the partnership would select either the fiscal year ending June 30 or the calendar year as its taxable year. However, since the partnership's current taxable year ends June 30, it must retain its current taxable year.

Test 12/31:	Year End	Interest in Partnership Profits	Months of Deferral for 12/31 Year End	Interest x Deferral
Partner A	12/31	.5	0	0
Partner B	6/30	.5	6	3.0
Aggregate deferral				3.0

Test 6/30:	Year End	Interest in Partnership Profits	Months of Deferral for 6/30 Year End	Interest x Deferral
Partner A	12/31	.5	6	3.0
Partner B	6/30	.5	0	0
Aggregate deferral				3.0

Example (4). The facts are the same as in *example (1)* except that on December 31, 1987, partner A sells a 4 percent interest in the partnership to Partner C, who reports income on the fiscal year ending June 30, and a 40 percent interest in the partnership to Partner D, who also reports income on the fiscal year ending unaffected by the sale. However, for the taxable year beginning July 1, 1988, the partnership must determine the taxable year resulting in the least aggregate deferral as of July 1, 1988. In this case, the partnership will be required to retain its taxable year since the fiscal year ending June 30 continues to be the taxable year that results in the least aggregate deferral of income to the partners.

Example (5). The facts are the same as in *example (4)* except that Partner D reports income on the fiscal year ending April 30. As in example (4), the taxable year during which the sale took place is unaffected by the shifts in interests. However, for its taxable year beginning July 1, 1988, the partnership will be required to change its taxable year to the fiscal year ending April 30. This determination is made as follows:

Test 7/31:	Year End	Interest in Partnership Profits	Months of Deferral for 7/31 Year End	Interest x Deferral
Partner A	6/30	.06	11	.66
Partner B	7/31	.5	0	0
Partner C	6/30	.04	11	.44
Partner D	4/30	.4	9	3.60
Aggregate deferral				4.70

Test 6/30:	Year End	Interest in Partnership Profits	Months of Deferral for 6/30 Year End	Interest x Deferral
Partner A	6/30	.06	0	0
Partner B	7/31	.5	1	.5
Partner C	6/30	.04	0	0
Partner D	4/30	.4	10	4.0
Aggregate deferral				4.5

Test 4/30:	Year End	Interest in Partnership Profits	Months of Deferral for 4/30 Year End	Interest x Deferral
Partner A	6/30	.06	2	.12
Partner B	7/31	.5	3	1.50
Partner C	6/30	.04	2	.08
Partner D	4/30	.4	0	0
Aggregate deferral				1.70

§1.706-1T(a)(4) Test:

Current taxable year (June 30)	4.5
Less: Taxable year producing the least aggregate deferral (April 30)	1.7
Additional aggregate deferral (greater than .5)	2.8

Example (6). Partnership P has two partners, A who reports income on the fiscal year ending March 31, and B who reports income on the fiscal year ending July 31. A and B share profits equally. P has determined its taxable year under §1.706-1T(a)(2) to be the fiscal year ending March 31 as follows:

Test 3/31:	Year End	Interest in Partnership Profits	Deferral for 3/31 Year End	Interest x Deferral
Partner A	3/31	.5	0	0
Partner B	7/31	.5	4	2
Aggregate deferral				2

Test 7/31:	Year End	Interest in Partnership Profits	Deferral for 7/31 Year End	Interest x Deferral
Partner A	3/31	.5	8	4
Partner B	7/31	.5	0	0
Aggregate deferral				4

In May 1988, Partner A sells a 45 percent interest in the partnership to C, who reports income on the fiscal year ending April 30. For the taxable period beginning April 1, 1989, the fiscal year ending April 30 is the taxable year that produces the least aggregate deferral of income to the partners. However, under paragraph (a)(4) of this section the partnership is required to retain its fiscal year ending March 31. This determination is made as follows:

Test 3/31:	Year End	Interest in Partnership Profits	Deferral for 3/31 Year End	Interest x Deferral
Partner A	3/31	.05	0	0
Partner B	7/31	.5	4	2.0
Partner C	4/30	.45	1	.45
Aggregate deferral				2.45

Test 7/31:	Year End	Interest in Partnership Profits	Deferral for 7/31 Year End	Interest x Deferral
Partner A	3/31	.05	8	.40
Partner B	7/31	.5	0	0
Partner C	4/30	.45	9	4.05
Aggregate deferral				4.45

Test 4/30:	Year End	Interest in Partnership Profits	Deferral for 4/30 Year End	Interest x Deferral
Partner A	3/31	.05	11	.55
Partner B	7/31	.5	3	1.50
Partner C	4/30	.45	0	0
Aggregate deferral				2.05

§1.706-1T(a)(4)

Test:

Current taxable year (3/31)	2.45
Less: Taxable year producing the least aggregate deferral (4/30)	2.05
Additional aggregate deferral (less than .5)	.40

OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

(26 CFR Part 602)

Par. 3. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805

Par. 4. Section 602.101(c) is amended by inserting in the appropriate place in the table: "§1.706-1T . . .1545-0099."

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue it with notice and public procedure under subsection (b) of section 553 of title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved December 16, 1987.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on December 24, 1987, 9:09 a.m., and published in the issue of the Federal Register for December 29, 1987, 52 F.R. 48994)

Section 708.—Continuation of Partnership

26 CFR 1.708-1: Continuation of partnership.

If a partnership terminates under section 708(b)(1)(B) of the Code and has no section 754 election in effect, it may make a section 754 election on its final return with respect to the transfer which caused the termination. See Rev. Rul. 88-42, page 265.

Section 709.—Treatment of Organization and Syndication Fees

26 CFR 1.709-2: Definitions.
(Also Sections 162, 212; 1.162-1, 1.212-1.)

Partnerships; treatment of the fee paid for a tax opinion. The fee paid by a syndicated limited partnership for the tax opinion used in the partnership's prospectus is a syndication expense chargeable by the partnership to a capital account and can not be amortized.

Rev. Rul. 88-4

ISSUE

Is the fee paid by a syndicated limited partnership for the tax opinion used in the partnership's prospectus a syndication expense under section 709 of the Internal Revenue Code?

FACTS

LP is a publicly syndicated limited partnership. *LP* engaged the services of *A*, a tax attorney, to prepare the tax opinion used in connection with the preparation of the tax section of the prospectus that was used to sell interests in *LP*. The fee paid to *A* covered the expense of researching, analyzing, developing, and drafting the opinion.

LAW AND ANALYSIS

Section 162(a) of the Code provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 212(3) of the Code provides that, in the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in connection with the determination, collection, or refund of any tax.

Section 709(a) of the Code provides that, except as provided in section 709(b), no deduction shall be allowed under chapter 1 of subtitle A of the Code to a partnership or to any partner for any amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such partnership.

Section 709(b) of the Code provides that amounts paid or incurred to organize a partnership may be allowed as a deduction ratably over a period of not less than 60 months beginning with the month in which the partnership begins business.

Section 1.709-2(a) of the Income Tax Regulations provides that organization expenses are expenses which: (1) are incident to the creation of the partnership, (2) are chargeable to capital account, and (3) are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would (but for section 709(a) of the Code) be amortized over such life.

Section 1.709-2(b) of the regulations provides that syndication expenses are expenses connected with the issuing and marketing of interests in the partnership. Included in the category of syndication expenses are (1) legal fees for securities advice and for advice pertaining to the adequacy of tax disclosures in the prospectus or placement memorandum for securities law purposes and (2) accounting fees for the preparation of representations to be included in the offering materials. Syndication expenses are not subject to the election under section 709(b) of the Code and must be capitalized.

For most syndicated partnerships, federal or state securities rules require that the prospectus or private placement memorandum contain a tax opinion or tax section setting forth the tax consequences to the investors. Moreover, the presence of a tax opinion in an offering of partnership interests is viewed as an important promotional feature which is useful in marketing the interests to investors.

In this case, the expense of preparing the tax opinion (including the expense of legal research and analysis performed with respect to the opinion, as well as the expense of developing and drafting the opinion) was incurred to comply with securities laws and to promote the marketing of partnership interests. Thus, the expense of preparing the tax opinion is a syndication expense under section 709 of the Code. *See Surloff v. Commissioner*, 81 T.C. 210, 245 (1983).

Section 709 of the Code specifically prohibits deductions under chapter 1 for any expense of organizing or syndicating a partnership. Therefore, if an expense falls within the scope of section 709, no deduction is allowable unless the expense is an organization expense that can be amortized as provided in section 709(b). Since the expense of the tax opinion is the type of expense described in section 709, it may not be deducted under section 162(a) or section 212(3). In addition, since the expense of the tax opinion is a syndication expense rather than an organization expense, it may not be amortized under section 709(b). *See*

Rev. Rul. 85-32, 1985-1 C.B. 186, which holds that syndication fees may not be amortized; *See also* section 1.709-2(b) of the regulations.

HOLDING

The fee paid by a syndicated limited partnership for the tax opinion used in connection with the preparation of the partnership prospectus is a syndication expense that may not be amortized under section 709(b) of the Code or deducted under section 162(a) or section 212(3). The fee must be capitalized by the partnership.

Part II.—Contributions, Distributions, and Transfers
Subpart D.—Provisions Common to Other Subparts

Section 754.—Manner of Electing Optional Adjustment to Basis of Partnership Property

26 CFR 1.754-1: Time and manner of making election to adjust basis of partnership property. (Also Section 708; 1.708-1.)

Partnerships; basis; section 754 election. A partnership that terminates under section 708(b)(1)(B) of the Code and that does not have a section 754 election in effect, may make a section 754 election on its final return which will be effective for the transfer that caused the termination.

Rev. Rul. 88-42

ISSUE

If a partnership makes an election on its final return to adjust the basis of partnership property pursuant to section 754 of the Internal Revenue Code, will that election be effective for the incoming partner whose purchase of a 50-percent interest in the partnership causes the partnership to terminate under section 708(b)(1)(B), so that the bases of partnership assets are adjusted prior to their deemed distribution?

FACTS

In 1983, *A* and *B* formed the *AB* partnership and each received a 50-percent interest in *AB*. *AB* filed returns on a calendar year basis. On June 30, 1986, *A* sold *A*'s 50-percent interest in *AB* to *C*. *AB* had not made a section 754 election as of the time of the sale. However, *AB* made the section 754 election in a written statement included with its timely filed partnership return for the short taxable year of January 1, 1986, to June 30, 1986.

LAW AND ANALYSIS

Section 708(b)(1)(B) of the Code provides that a partnership shall be considered as terminated if within a 12-month period there is a sale or exchange of 50-percent or more of the total interest in partnership capital and profits.

Section 1.708-1(b)(1)(iii)(*b*) of the Income Tax Regulations provides that the termination of a partnership pursuant to section 708(b)(1)(B) of the Code closes the terminating partnership's taxable year on the date of the sale or exchange of a partnership interest which transfers an interest of 50-percent or more in both partnership capital and profits. *See* section 706(c)(1) and section 1.706-1(c) of the regulations.

Section 1.708-1(b)(1)(iv) of the regulations provides that if a partnership is terminated by a sale or exchange of an interest, the partnership is deemed to distribute its properties to the purchaser and the other remaining partners in proportion to their respective interests in the partnership properties. Immediately thereafter, the purchaser and the other remaining partners are deemed to contribute the properties to a new partnership.

Section 743(a) of the Code provides that the basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless the election provided by section 754 (relating to optional adjustment of basis of partnership property) is in effect with respect to such partnership.

Section 754 of the Code provides the manner in which a partnership shall file an election to adjust the basis of partnership property under section 743.

Section 1.754-1(a) of the regulations provides that an election made under section 754 of the Code applies to all property distributions and transfers of partnership interests taking place in the partnership taxable year for which the election is made and in all subsequent years unless revoked pursuant to section 1.754-1(c).

Section 1.754-1(b)(1) of the regulations provides that the election is made in a written statement filed with the partnership return for the taxable year during which the distribution or transfer occurs. For the election to be valid, the return must be timely filed in accordance with the regulations.

Section 1.754-1(b)(2) of the regulations sets forth an example of the application of section 1.754-1(b). In that example, an interest is sold in a partnership that had not previously made a section 754 election. The example holds that a section 754 election may be made in a written statement filed with the partnership return for the year in which that sale is made and that it will be effective for all distributions of property to a partner and to all transfers of interests in the partnership occurring in the year of sale and subsequent years,, unless revoked pursuant to section 1.754-1(c).

Rev. Rul. 86-73, 1986-1 C.B. 282, considers a sale of a 50-percent interest in a partnership that has a section 754 election in effect. The ruling concludes that the section 754 election in effect for the taxable year in which the sale occurs applies with respect to the incoming partner because that partner is considered to be a partner of the terminating partnership for the instant prior to its termination. Therefore, the bases of the partnership's assets must be adjusted prior to the termination and deemed distribution to the incoming partner.

In the present case, the sale of the 50-percent interest on June 30, 1986, to *C* terminates *AB* pursuant to section 708(b)(1)(B) of the Code, causing a short taxable year of January 1, 1986, to June 30, 1986. *See* section 1.708-1(b)(1)(iii)(*b*) of the regulations. The terminating partnership made a section 754 election on its final return. That election was effective for all property distributions and transfers of partnership interests made in the short year ending June 30, 1986. Applying the principles of Rev. Rul. 86-73, *C* is considered a partner of *AB* immediately prior to *AB*'s termination and, thus, during *AB*'s short year ended June 30, 1986 Therefore, the bases of the partnership assets will be correspondingly adjusted prior to the deemed distribution to C. If the new partnership, *BC*, wants to make a section 754 election, it will have to file a new election.

HOLDING

If a partnership makes an election on its final return to adjust the basis of partnership property pursuant to section 754 of the Code, that election is effective for the incoming partner whose purchase of a 50-percent interest in the partnership causes the partnership to terminate under section 708(b)(1)(B). The bases of partnership assets are adjusted pursuant to sections 743(b) and 755 prior to their deemed distribution to the incoming partner.

Subchapter L.—Insurance Companies
Part I.—Life Insurance Companies
Subpart C.—Life Insurance Deductions

Section 807.—Rules For Certain Reserves

26 CFR 1.807-1T: Mortality and morbidity tables (temporary).
(Also Section 846.)

Life insurance companies; interest rate. For purposes of section 807 of the Code, the applicable federal interest rate determined under section 846(c) for 1988 is announced that is used in computing the amount of a life insurance company's federally prescribed life insurance reserves.

Rev. Rul. 88-16

Section 10241 of the Revenue Act of 1987, 1987-3 C.B., amended section 807(d)(2)(B) of the Internal Revenue Code (relating to method of computing reserves for purposes of determining the income or loss of a life insurance company). Prior to the amendment, the interest rate to be applied in computing the amount of a life insurance company's federally prescribed life insurance reserves for any contract was the "prevailing state assumed interest rate" (generally, the highest assumed interest rate permitted to be used in at least 26 States in computing life insurance reserves for insurance or annuity contracts of that type as of the beginning of the calendar year in which the contract is issued). As amended, section 807(d)(2)(B) provides that the interest rate used to compute a life insurance company's life insurance reserves is the greater of the applicable federal interest rate or the prevailing state assumed interest rate. The amendment to section 807 is effective for contracts issued in taxable years beginning after December 31, 1987.

Section 807(d)(4) of the Code, as amended, defines the term "applicable federal interest rate" to mean the annual rate determined by the Secretary under section 846(c)(2) for the calendar year in which the contract was issued. Section 846(c)(2) provides that the annual rate determined by the Secretary for any calendar year shall be a rate equal to the average of the applicable federal mid-term rates (as defined in section 1274(d) but based on annual compounding) effective as of the beginning of each of the calendar months in the test period. The test period is the most recent 60-calendar-month period ending before the beginning of the calendar year for which the determination is made, except that there shall be excluded from the test period any month beginning before August 1, 1986.

The applicable interest rate for 1988 determined under section 846(c) of the Code is 7.77 percent. Therefore, for purposes of section 807, the applicable federal interest rate for 1988 is 7.77 percent.

In the future, the applicable federal interest rate for purposes of sections 846(c) and 807 of the Code will be published yearly in the revenue ruling containing the applicable federal rates for December. For example, the applicable federal interest rate for 1989 for purposes of sections 846 and 807 will be published in the revenue ruling containing the applicable federal rates for December 1988.

Part II.—Other Insurance Companies

Section 832.—Insurance Company Taxable Income

26 CFR 1.832-4T: Gross income.

T.D. 8171

Title 26.—INTERNAL REVENUE—CHAPTER 1, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Treatment of Salvage and Reinsurance Under Section 832(b)

AGENCY: Internal Revenue Service, Treasury

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the treatment of salvage and reinsurance in determining the paid and unpaid losses of property and casualty insurance companies. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations for the notice of proposed rulemaking *** [page 930, this Bulletin]. The temporary regulations are issued because the current treatment of salvage and reinsurance does not result in an accurate reflection of income for federal tax purposes. The regulations affect insurance companies taxable under section 831(a). The Service will issue guidance making it clear that the principles of these regulations also apply to the treatment of salvage and reinsurance in determining a life insurance company's paid and unpaid losses on contracts other than life insurance contracts. See sections 811(a), 807(c), and 816(c) of the Internal Revenue Code of 1986 and the regulations thereunder.

DATES: The regulations are effective as of January 1, 1988, and apply to taxable years beginning after December 31, 1987.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document amends the Income Tax Regulations (26 CFR Part 1) to provide rules under section 832(b)(5) of the Internal Revenue Code of 1986.

EXPLANATIONS OF PROVISIONS

Under section 832(b) the gross income of a property and casualty insurance company includes its underwriting income. Underwriting income means premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred. Section 832(b)(5) provides that losses incurred are generally computed by deducting any increase in salvage and reinsurance recoverable from paid losses, and to that result adding any increase in unpaid losses. (The Tax Reform Act of 1986 [1986-3 C.B. (Vol.1) 1] provides for the discounting of unpaid losses to reflect the time value of money. The discounting of unpaid losses is expected to be the subject of another regulation project. That project is expected to address the proper treatment, under section 846(g)(2), of salvage and reinsurance attributable to unpaid losses, where such amounts are not taken into account in determining the unpaid losses shown in the annual statement filed by the taxpayer, and hence are not reflected in the taxpayer's "undiscounted unpaid losses," as defined in section 846(b)(1)).

Although the statute clearly requires that paid losses be adjusted to take into account salvage recoverable (i.e., salvage not reduced to cash or cash equivalents), this adjustment generally has not been made. In 1947, the Internal Revenue Service promulgated regulations under section 832 that provided for the exclusion from salvage recoverable of an item if any state in which the taxpayer transacted business prohibited the taxpayer from reporting such an item for annual statement purposes. Several states have rules prohibiting the reporting of any salvage recoverable. These rules reflect the generally conservative nature of state reporting measures, which are designed primarily to ensure the solvency of insurance companies. After the 1947 regulations were issued, many insurance companies began transacting business in states that prohibited the reporting of salvage recoverable. There remained, however, certain regional companies which did not transact business in such states. These companies were required to take salvage recoverable into account. Despite this disparity in treatment, the exclusion of salvage recoverable was upheld in *Continental Insurance Co. v. United States*, 474 F.2d 661 (Ct. Cl. 1973).

The exclusion of salvage recoverable, while consistent with state regulatory ends, does not result in an accurate reflection of income for federal tax purposes. Those purposes are best served by a close matching of income and expenses. The temporary regulations, therefore, amend §1.832-4(c) to require that paid losses be adjusted by all salvage recoverable attributable to such paid losses, regardless of how the salvage recoverable is reported for annual statement purposes.

Section 1.832-4(b) of the regulations provides that the taxpayer must establish "that the part of the deduction for 'losses incurred' which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay." The temporary regulations amend §1.832-4(b) of the regulations to clarify that, in making a "fair and reasonable estimate of the amount the company will be required to pay," estimated recoveries on account of salvage and reinsurance attributable to unpaid losses must be taken into account.

Thus, the temporary regulations provide that salvage and reinsurance recoverable attributable to paid losses must be taken into account under section 832(b)(5)(A)(i) as an adjustment to paid losses. Estimated recoveries on account of salvage and reinsurance attributable to unpaid losses must be taken into account in calculating the reserve for unpaid losses under section 832(b)(5)(A)(ii).

In addition, the temporary regulations address the adjustments that must be made if the temporary regulations require an insurance company to change its method of accounting for salvage and reinsurance. The temporary regulations provide that the fresh start of section 1023(e) of the Tax Reform Act of 1986 is not applicable to such a change in accounting method.

Finally, the temporary regulations make explicit that the term "salvage" includes subrogation claims. The temporary regulations do not thereby change the law concerning the meaning of salvage (as illustrated by *Continental Insurance Co. v. United States*, 474 F.2d 661 (Ct. Cl. 1973)), and no inference should be drawn with respect to any section of the Internal Revenue Code or the regulations thereunder that any change is intended.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that the temporary rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, these temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

• • • •

Amendments to the regulations

For the reasons set out in the preamble, Title 26, Chapter 1, Subchapter A, Part 1 of the Code of Federal Regulations is amended as set forth below:

INCOME TAX REGULATIONS
(26 CFR Part 1)

Paragraph 1. The authority for Part 1 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 2. Section 1.832-4 is redesignated as §1.832-4T and amended by revising the caption, adding a new sentence at the end of paragraph (a)(5), revising paragraphs (b) and (c), and adding paragraphs (d) and (e) to read as follows:

§1.832-4T Gross income (temporary).

(a) ***

• • • • •

(5) *** See paragraph (b) of this section for rules relating to the treatment of salvage and reinsurance in determining unpaid losses.

(b) Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, represent a fair and reasonable estimate of the amount the company will be required to pay. Estimated recoveries on account of salvage and reinsurance attributable to unpaid losses must be taken into account in the computation of unpaid losses. The amounts of such expected recoveries should be estimated based upon the facts in each case and the company's experience with similar cases. Amounts included in, or added to, the estimates of unpaid losses which, in the opinion of the district director, are in excess of the actual liability determined as provided in the preceding sentences will be disallowed as a deduction. The district director may require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

(c) That part of the deduction for "losses incurred" which representes an adjustment to losses paid for salvage and reinsurance recoverable shall include all salvage in course of liquidation, and all reinsurance in process of collection not otherwise taken into account as a reduction of losses paid, outstanding at the end of the taxable year. Salvage in course of liquidation includes all property (other than cash or cash equivalents), real or personal, tangible or intangible. Such salvage in course of liquidation shall be taken into account to the extent of the value thereof at the end of the taxable year as determined from a fair and reasonable estimate based upon either the facts in each case or the company's experience with similar cases. Cash or cash equivalents received during the taxable year with respect to items of salvage or reinsurance shall reduce losses paid during such taxable year. For purposes of this section the term "salvage" includes subrogation claims.

(d)(1) The treatment of salvage and reinsurance is a method of accounting. Every insurance company to which this section applies that did not treat salvage and reinsurance as provided in this section for the last taxable year beginning before January 1, 1988, must change its method of accounting with respect to salvage and reinsurance in the first taxable year beginning after December 31, 1987. The change in method of accounting will result in a section 481(a) adjustment. The fresh start provision of section 1023(e) of the Tax Reform Act of 1986 does not apply to the change in method of accounting required by this paragraph (d)(1).

(2) In the case of any insurance company required by paragraph (d)(1) of this section to change its method of accounting for any taxable year, such change shall be treated as initiated by the taxpayer and made with the consent of the Commissioner.

(3) Any insurance company required to change its method of accounting under paragraph (d)(1) of this section shall take the required adjustment into account as provided in applicable administrative procedures.

(e) This section is effective for taxable years beginning after December 31, 1987. In computing unpaid losses for taxable years beginning before January 1, 1988, an insurance company to which this section applies is not required to take into account estimated recoveries on account of salvage attributable to unpaid losses. In addition, in computing paid losses for such taxable years, an insurance company to which this section applies is not required to take into account salvage recoverable if during such taxable years the inclusion of such salvage was prohibited by the laws of a state in which the company transacted business.

There is a need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason it is impracticable to issue this Treasury decision with notice and public procedure under section (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved December 22, 1987.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on December 30, 1987, 1:51 p.m., and published in the issue of the Federal Register for January 5, 1988, 53 F.R. 117)

Part III.—Provisions of General Application

Section 846.—Discounted Unpaid Losses Defined

The applicable interest rate determined under section 846(c) of the Code for 1988 is announced that is used in computing under section 807 the amount of a life insurance company's federally prescribed life insurance reserves. See Rev. Rul. 88-16, page 266.

Subchapter M.—Regulated Investment Companies and Real Estate Investment Trusts
Part I.—Regulated Investment Companies

Section 851.—Definition of Regulated Investment Company

New section 851(q), which provides that each fund of a series investment company is a separate corporation, renders Rev. Rul. 56-246 obsolete. See Rev. Rul. 88-14, page 405.

Section 852.—Taxation of Regulated Investment Companies and Their Shareholders

26 CFR 1.852-1: Taxation of regulated investment companies.

If a regulated investment company that is also a personal holding company retains income, and thus has investment company taxable income and undistributed personal holding company income, is the company liable for tax under both section 541 and 852(b)(1) of the Code? See Rev. Rul. 88-41, page 253.

Subchapter N.—Tax Based on Income from Sources Within or Without the United States
Part I.—Determination of Sources of Income

Section 864.—Definitions and Special Rules

26 CFR 1.864-2: Trade or business within the United States.

Trade or business within the U.S.; determination. The determination whether a taxpayer is engaged in a trade or business within the U.S. is highly factual and such a determination is not ordinarily made in an advance ruling. Rev. Rul. 73-227 revoked.

Rev. Rul. 88-3

Rev. Rul. 73-227, 1973-1 C.B. 338, examines the activities of *X*, the foreign financing subsidiary of a United States parent, and holds that the United States source interest income that *X* earns is effectively connected with a United States trade or business under section 864(c) of the Internal Revenue Code of 1954.

Section 864(b) of the Code and the regulations promulgated thereunder provide rules for determining whether a foreign taxpayer is engaged in a trade or business within the United States. (These rules may differ in some respects from those used in determining whether a taxpayer is engaged in a trade or business under other sections of the Code.) The determination whether *X* is engaged in a trade or business within the United States must therefore be made by applying these rules to the facts described in the ruling. Rev. Rul. 73–227, however, does not do so. The ruling simply concludes without discussion of the applicable statute and regulations that *X* is engaged in a trade or business within the United States. Because the ruling does not discuss and apply the proper legal standard, its conclusion may be unsound.

In addition, the determination whether a taxpayer is engaged in a trade or business within the United States is highly factual. Such a determination is not ordinarily made in an advance ruling. *See* sections 2.01 and 4.01(2) of Rev. Proc. 87–6, 1987–1 C.B. 541.

Accordingly, Rev. Rul. 73–227 is revoked. Determinations under section 864 of the Code must be made by applying the regulations promulgated thereunder to the facts and circumstances of each case.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 73–227 is revoked.

Part II.—Nonresident Aliens and Foreign Corporations
Subpart C.—Miscellaneous Provisions

Section 892.—Income of Foreign Governments and of International Organizations

26 CFR 1.892-1: Income of foreign governments.
(Also Sections 1441, 1442; 1.1441-2, 1.1442-1.)

United Kingdom. Income of superannuation funds of England, Wales, and Scotland is exempt from U.S. income tax and is not subject to withholding under section 1441 or 1442 of the Code. Rev. Rul. 72–183 amplified and Rev. Rul. 84–28 distinguished.

Rev. Rul. 88–7

ISSUE

Is income received by local governmental authorities of England, Wales, and Scotland from certain United States investments allocable to their superannuation funds exempt from Federal income taxation under section 892 of the Internal Revenue Code of 1986, and therefore not subject to withholding under sections 1441 ot 1442 of the Code?

FACTS

The United Kingdom Superannuation Act of 1972 permits local governmental authorities in England, Wales, and Scotland to establish investment reserves in the form of superannuation funds ("Funds") to provide retirement and other benefits to government employees and certain other employees within their jurisdiction. In England and Wales, such Funds have been established by three types of local governmental authorities:

1. the non-metropolitan county councils established by the Local Government Act 1972;
2. the residuary bodies and district councils that, under sections 60 and 66 of the Local Government Act 1985, assumed responsibility for Funds previously established by the former metropolitan county councils and the Greater London Council; and
3. the inner and outer London Borough Councils established by the Local Government Act 1963.

In Scotland, Funds have been established by the regional councils, the Orkney Islands Council, and the Shetland Islands Council.

The county councils, district councils, residuary bodies, inner and outer borough councils, regional councils, and island councils ("Councils") were established by an act of Parliament. They provide governmental services to inhabitants within their jurisdiction. Upon dissolution, no assets of the Councils vest in any private person. Rather, such assets vest in a successor body designated by Parliament, or in Parliament itself. None of the Councils engages in commercial activities within or outside the United States.

Each Council may provide pension benefits from its Fund or otherwise to its own employees, employees of other United Kingdom governmental bodies, employees of certain educational institutions in the local jurisdictions, and eligible employees of certain bodies that are admitted into the Fund ("admitted bodies"). Admitted bodies are institutions that perform governmental or social services, such as associations for the blind, schools for the deaf, social centers for the elderly, port and harbor commissions, and library systems.

A Council establishes a Fund simply by allocating to a separate account specific assets that thereafter are held for Fund purposes. Each Council is responsible for the administration, collection, and investment of fund assets and is directly responsible to pensioners for payment of their pensions. Each Council is required to maintain a separate record of all receipts, payments, and earnings allocable to its Fund. The money and assets allocated to a Fund are the property of the Council and may be used as security for the Council's external borrowings. The right to collect contributions from employers and employees, the duty to pay pension benefits, and the obligation to invest or lend surplus moneys allocable to the Fund are rights, duties, and obligations enforceable by and against the Council and not the Fund.

Each Council invests a portion of the assets allocable to its Fund in stocks and securities of United States corporations and receives dividend and interest income with respect to such investments. None of these investments represents an investment in a controlled commercial entity as defined by section 892(a)(1)(B) of the Code, and no amounts are received as rents, royalties, or similar payments. These investments in United States stocks and securities are the sole activities of the Councils in the United States.

LAW AND ANALYSIS

Section 892(a)(1) of the Code excludes from gross income and exempts from income taxation the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities owned by such foreign governments; income received from financial instruments held in the execution of governmental financial or monetary policy; and interest on deposits in banks in the United States of moneys belonging to such foreign governments. Section 892(a)(2)(A) provides that this exclusion does not apply to income derived from the conduct of any commercial activity, whether within or outside the United States, or to income received from or by a controlled commercial entity. Sections 1441 and 1442 provide for withholding of tax on payments made to nonresident aliens and foreign corporations that are subject to tax under sections 871(a) and 881(a). Income exempt under section 892 is not subject to withholding under sections 1441 and 1442.

For purposes of section 892 of the Code, a foreign government consists only of integral parts or controlled entities of a foreign sovereign. Section 1.892-1(b)(2) of the Income Tax Regulations provides that an integral part of a foreign sovereign is any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country. Section 1.892-1(b)(5) of the regulations provides that the rules that apply to a foreign sovereign apply to political subdivisions of a foreign country. Under these rules, the Councils are a governing authority of a foreign country for purposes of section 892.

Section 1.892-1(b)(2) of the regulations requires that the net earnings of the governing authority must be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person. The earnings of the Funds are used to provide benefits to both governmental and non-governmental employees. Earnings used to provide retirement benefits to the governmental employees are not considered to inure to the benefit of private persons; *see* Rev. Rul. 72-183, 1972-1 C.B. 213, which provides that income earned by a retirement fund for employees of the Organization for Economic Cooperation and Development is exempt from tax under section 892 of the Code.

Earnings used to provide retirement benefits to the non-governmental employees—persons employed by certain local educational institutions and by the admitted bodies—likewise do not inure to the benefit of private persons. Although the employing entities are not themselves integral parts of the foreign government, their activities are not conducted with a view towards the production of income and are therefore not commercial in nature. *Cf.* section 1.892-1(c)(1) of the regulations. Therefore, no part of any Fund earnings inures to the benefit of private persons, and income described in section 892(a) of the Code used by the Councils to provide retirement benefits to governmental employees, employees of certain educational institutions, and employees of admitted bodies is exempt under section 892.

The treatment of the Funds differs from that of an independent pension trust for purposes of section 892 of the Code. A pension trust is a separate juridical entity and must qualify as a controlled entity in order for its income to be potentially exempt under section 892. A pension trust will qualify as a controlled entity only if it is established exclusively for employees or former employees of a foreign government. *See* Rev. Rul. 84-28, 1984-1 C.B. 177.

The Funds established by the Councils provide pension benefits to some non-governmental employees. However, Funds are simply assets of the Councils and are not separate pension trusts. Therefore, the restrictions imposed on pension trusts do not apply.

HOLDING

Income received from investments allocable to the Funds maintained by the Councils is considered to be received by a foreign government within the meaning of section 892 of the Code. Therefore, income described in section 892(a) that is received by the Councils from investments allocable to the Funds is exempt from Federal income taxation under section 892 and is not subject to withholding under sections 1441 or 1442.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 72-183 is amplified. Rev. Rul. 84-28 is distinguished.

Section 897.—Disposition of Investment in United States Real Property

When a foreign corporation becomes a domestic corporation pursuant to a state domestication statute, section 897 will apply to the transaction. See Rev. Rul. 88-25, page 116.

---

26 CFR 1.897-5T: Corporate distributions (temporary).

T.D. 8198

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Corporate Distributions and Certain Nonrecognition Exchange and Other Transfers Under Section 897(c), (d), (e), (g), (i) and (j) and Section 367(e)(2) and Withholding Under Section 1445(e)(5) and (6).

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document provides temporary Income Tax Regulations relating to certain dispositions of U.S. real property interests. The regulations provide rules for the exchange, distribution, or transfer of U.S. real property interests without recognition of gain under the Foreign Investment in Real Property Tax Act of 1980. The regulations also treat interests in certain partnerships as entirely U.S. real property interests for purposes of withholding on the proceeds from dispositions of such interests. In addition, the regulations provide rules with respect to the treatment of interests in publicly traded corporations. The text of the temporary regulations set forth in this document serves as the text of the proposed regulations *** [INTL-491-87, page 921, this Bulletin].

DATES: Except as otherwise specifically provided, §§1.897-4AT, 1.897-5T, and 1.897-6T apply to exchanges, distributions, or transfers of U.S. real property interests occurring after June 18, 1980, and are effective as of that date. Changes and additions to portions of the existing regulations made by §§1.897-7T, 1.897-8T, 1.897-9T except paragraph (e), 1.1445-10T, and 1.1445-11T are generally effective after June 6, 1988. Paragraph (e) of §1.897-9T dealing with foreign governments and international organizations is effective July 1, 1986. The special rules of §1.1445-9T for section 1034 nonrecognition are effective after August 3, 1988.

SUPPLEMENTARY INFORMATION

BACKGROUND

This document contains temporary Income Tax Regulations (26 CFR Part 1) under section 897(c), (d), (e), (g), (i) and (j) of the Internal Revenue Code of 1986, as added by section 1122 of the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") (94 Stat. 2599, 2682, Pub. L. 96-499)[1980-2 C.B. 509] and amended by section 831 of the Economic Recovery Tax Act of 1981 (95 Stat. 172, 352, Pub. L. 97-34). This document also contains limited temporary Income Tax Regulations (26 CFR Part 1) under the authority of section 367(e)(2) of the Internal Revenue Code of 1986, as added by section 631(d)(1) of the Tax Reform Act of 1986 (100 Stat. 2085, 2272, Pub. L. 99-514) [1986-3 (Vol.1) C.B. 1, 189]. The regulations are issued under the authority contained in section 897(d), (e), (g), and (j), section 1125(d) of FIRPTA, section 367(e)(2), section 1445(e)(5) and (6), and section 7805(a).

Section 897(a) of the Internal Revenue Code treats gain or loss derived by nonresident alien individuals or foreign corporations from the disposition of U.S. real property interest as if such gain or loss were effectively connected with a U.S. trade or business. Sections 897(d), (e), and (g) provide rules for the application of section 897(a) to certain distributions and nonrecognition exchanges. Section 897(c) provides, *inter alia*, a rule excepting from treatment as U.S. real property interests certain interests in publicly traded domestic corporations. The temporary regulations under section 367(e)(2) relate to the liquidation of certain corporations holding U.S. real property interests. The regulations under section 1445(e)(6) require withholding in certain instances on the disposition of partnership interests and on the distribution of U.S. real property interests by partnerships.

DISCUSSION

Section 897(d) in general

Section 897(d)(1) provides, in general, that gain shall be recognized by a foreign corporation on its distribution, including by way of liquidation or redemption, of a United States real property interest, except to the extent otherwise provided in regulations. The gain recognized is the excess of the fair market value of such interest as of the time of the distribution over its adjusted basis.

Section 897(d)(2) provides that gain is not recognized under section 897(d)(1) if certain conditions are satisfied. The conditions are that, at the time of the receipt of the property, the distributee would be subject to income taxation on a subsequent disposition of the property, and the basis of the property is no greater than the adjusted basis of such property before the disposition increased by the amount of gain recognized by the distributing corporation.

Distributions by Domestic Corporations

Generally, the basis of property received by a foreign shareholder from a domestic corporation in a section 301 distribution is determined under section 301(b). Section 897(f) provides that, in the case of a distribution of a United States real property interest by a domestic corporation to a foreign shareholder, such shareholder's basis shall not exceed the adjusted basis of the property before the distribution in the hands of the domestic corporation increased by gain recognized by the domestic corporation on the distribution that is subject to U.S. taxation and increased by any U.S. tax paid by or on behalf of the foreign shareholder with respect to the distribution.

If a corporation that is a United States real property holding corporation distributes property to a foreign shareholder with respect to its stock, the foreign shareholder is treated as having disposed of a United States real property interest. Gain or loss is recognized to the extent that part or all of the distribution is treated under sections 301(c)(3)(A), 302(a), or 331(a) as made in full payment in exchange for stock.

If a United States real property holding corporation completely liquidates under section 331(a) after the repeal of the *General Utilities* doctrine, and all gain is recognized at the U.S. corporate level under section 336(a), there is no further shareholder level tax under section 897(a) with respect to the section 331 exchange. Under the cleansing provision of section 897(c)(1)(B), the shares in the U.S. corporation are not treated as U.S. real property interests.

If a corporation (other than certain corporations making an effective election under section 897(i)) that is a United States real property holding corporation distributes property after July 31, 1986 and after the repeal of the *General Utilities* doctrine under sections 332 and 334(b)(1) to an 80 percent foreign corporate shareholder with respect to its stock, the foreign corporate shareholder is not treated as having disposed of a United States real property interest in a recognition transaction. The foreign corporate shareholder's basis in the U.S. real property interest will be the same as in the hands of the domestic corporation. The consequences of the transaction under section 367(e)(2) are also clarified.

Rules are provided for foreign corporations that have elected under section 897(i) to be treated as domestic corporations for purposes of section 897. A rule is also provided for section 333 elections.

Distributions by Foreign Corporations

A foreign corporation that distributes a United States real property interest must recognize gain, but not loss, on the distribution except as otherwise provided. Gain is not recognized by a foreign corporation if, at the time of the distribution, the recipient shareholder would be subject to United States taxation in accordance with the provisions of the regulations on a subsequent disposition of the United States real property interest, and the recipient shareholder's basis in the United States real property interest is equal to or less than the basis of the property in the corporation's hand increased by the amount of gain recognized by the corporation. Regulations for determining the distributee's basis in the distributed property are provided.

The distributing foreign corporation in a liquidation distribution to its 80 percent foreign corporate shareholder after July 31, 1986, under sections 332(a), 337(a) and 367(e)(2) shall not recognize gain on the U.S. real property interests distributed.

Regulations are provided for certain section 355 distributions by foreign corporations and the distribution of domestic corporation stock by a foreign corporation in a reorganization under section 368(a)(1)(C), (D), or (F). The Service invites comments concerning alternative methods of treating the distribution of domestic corporation stock by a foreign corporation in an inbound reorganization such as basis adjustments. An anti-abuse rule that treats certain stock transfers followed by a liquidation as an inbound reorganization is also provided.

A foreign corporation may not use section 337 as in effect prior to the Tax Reform Act of 1986 to sell a U.S. real property interest.

The regulations also include a provision for the section 897(l) credit in complete liquidations.

General Nonrecognition Rules

Nonrecognition of gain or loss may be obtained with respect to certain distributions or exchanges under proposed §§1.897-5T and 1.897-6T of United States real property interests if the interests are subject to United States taxation on subsequent disposition. Certain procedural requirements must also be fulfilled. If a recipient waives the otherwise applicable benefits of a United States income tax treaty, an interest otherwise qualifying shall be considered to be subject to United States taxation upon its subsequent disposition.

Section 897(e) in general

Section 897(e)(1) provides that any nonrecognition provision shall apply to a transaction only in the case of an exchange of a United States real property interest for an interest the sale of which would be subject to United States taxation.

Section 897(e)(2) authorizes the Secretary to issue necessary or appropriate regulations to prevent the avoidance of Federal income taxes. These regulations provide the extent to which nonrecognition provisions shall apply under section 897, and the extent to which transfers of property in reorganizations shall be treated as sales of property at fair market value.

Nonrecognition Exchanges

The regulation provides that a nonrecognition provision shall apply to a transfer of a United States real property interest by a foreign person only to the extent that a United States real property interest is exchanged for a United States real property interest which immediately following the exchange would be subject to United States taxation upon its disposition. An interest is subject to United States taxation upon its disposition in accordance with the general nonrecognition rules described above. A nonrecognition provision is any provision of the Code which provides that gain or loss shall not be recognized if the requirements of that provision are met. If the nonrecognition provision does not apply, then the interest transferred is subject to taxation under section 897.

If a nonrecognition provision applies to the transfer of a United States real property interest, then the basis of the property received by the transferor is determined under the generally applicable rules. The basis of the exchanged property received by the transferee is determined under the generally applicable rules. If the transferor recognizes gain on the exchange of a United States real property interest, then the transferee's basis in the property will be increased if the generally applicable rules so provide.

A transferor that receives nonqualifying property, such as a foreign real property interest, in addition to United States real property interests subject to United States tax on disposition must recognize gain or loss equal to the lesser of either (1) the sum of the cash received plus the fair market value of the nonqualifying property received, or (2) the gain or loss realized with respect to the United States real property interest transferred. Specific rules are provided for mixed exchanges where both a United States real property interest and other property (including cash) is transferred in exchange both for qualifying and nonqualifying property.

Rules are also provided for certain foreign to foreign transfers in section 361 transactions, and contributions to capital under section 897(j).

Anti-Abuse Provisions

Rules denying nonrecognition with respect to certain tax avoidance transfers are provided. These include certain transfers by foreign persons to domestic corporations, basis adjustment for certain related person transactions, and the rearrangement of ownership to gain a treaty benefit.

Partnership Interests—Section 897(g) and Section 1445(e)

An interest in a partnership in which fifty percent or more in value of the gross assets consist of U.S. real property interests and ninety percent or more of the value of the gross assets consist of U.S. real property interests and cash or cash equivalents is considered entirely a U.S. real property interest for purposes of withholding on dispositions of such interests.

Section 1034 Rollovers—Sections 897(e) and 1445

A rule is provided under section 897(e) that permits a nonresident alien individual to utilize section 1034 on the sale of a principal residence that is a U.S. real property interest when another U.S. real property interest is purchased and used as a principal residence within a two year period before or after the sale. Gain recognition is required if the principal residence purchased is not a U.S. real property interest. Special withholding rules under section 1445 are also provided with respect to the sale of a principal residence for more than $300,000.

Section 897(i) Elections—U.S. real property holding corporation status required

A rule is provided under section 897(i) that requires that a foreign corporation making an election under that provision must be a U.S. real property holding corporation.

Section 897(a)—Definition of foreign persons

The definition of foreign person in the regulations under section 897(a) is clarified to explain under which circumstances a foreign government is taxable under (or subject to) sections 897, 1445, and 6039C.

Section 897(c)(3) in general

Section 897(c)(3) excepts certain interests in a U.S. real property holding corporation from treatment as a U.S. real property interest. Dispositions by foreign persons of interests in a U.S. corporation which are not treated as U.S. real property interests are not subject to tax under section 897. Beneficial ownership of an interest of five percent or less of any class of stock of a domestic corporation which is regularly traded on an established securities market is not treated as a U.S. real property interest. In addition, the current regulations provide that any other interest in a domestic U.S. real property holding corporation is not treated as a U.S. real property interest if the fair market value of the interest is five percent or less of the fair market value of the regularly traded class of stock of the U.S. real property holding corporation with the lowest fair market value. The regulations under section 897(c)(3) are being modified in the following respects.

Interests Traded on Foreign Securities Markets

Interests in a domestic corporation traded on foreign securities markets must be registered pursuant to the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. 78, to be treated as "regularly traded" interests for purposes of section 897(c)(3). This rule is modified to provide an alternative reporting requirement for corporations not otherwise required to register under the 1934 Act. In lieu of registration with the SEC, such corporations may file with the Service a report disclosing the beneficial owners of interests greater than 5 percent of any class of interests in the corporation which are traded on foreign securities markets, and such other identifying information as the Service requires. In addition, a class of interest traded on foreign securities markets must satisfy certain volume requirements to be treated as regularly traded within the meaning of section 897(c)(3).

Non-Regularly Traded Interests in Publicly Traded Corporations

Beneficial ownership of an interest in a domestic U.S. real property holding corporation which is not itself regularly traded is treated as a U.S. real property interest only if the fair market value of the interest on the date it was acquired is greater than five percent of the fair market value of the regularly traded class of interests of the U.S. real property holding corporation having the lowest fair market value. This rule is modified to provide that beneficial ownership of an interest in a class of non-regularly traded convertible interests in a domestic U.S. real property holding corporation will be treated as a U.S. real property interest only if the interest is greater than 5 percent of the fair market value of the class of stock into which the interest is convertible.

Need for Temporary Regulations

These regulations, if adopted, would generally apply to all transactions occurring after June 18, 1980. However, §1.897-5T(b)(2)(iv) applies only to certain transactions occurring after July 31, 1986; §§1.897-7T, 1.897-8T, and 1.1445-10T apply only to certain transactions occurring 30 days after publication of this document in the Federal Register, and §1.1445-9T applies only to certain transfers occurring 90 days after publication of this document in the Federal Register.

The temporary regulations will clarify unsettled law in this area, and provide taxpayers with needed immediate guidance. Many taxpayers have not been able to effectuate transactions, such as corporate reorganizations, because of the lack of regulatory guidance. This effective date is also necessary to prevent avoidance of tax.

The effective date for §1.897-5(b)(2)(iv) corresponds with the effective date of the repeal of the *General Utilities* doctrine. The concepts underlying the repeal of the *General Utilities* doctrine are incorporated in the proposed regulations. The effective date of paragraph (e) of §1.897-9T corresponds with the effective date of the amendment of section 892 by the Tax Reform Act of 1986.

The extraordinary, retroactive regulatory relief from the rules of section 897(d) and (e) has been provided because these regulations are considered to be issued under unusual circumstances.

For all of these reasons, this regulation is not issued subject to the public notice requirements of 5 U.S.C. section 553(b) or to the effective date limitation of paragraph (d) of that section.

SPECIAL ANALYSES

It has been determined that these temporary regulations are not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. It has also been determined that these regulations will not have a significant impact on a substantial number of small entities. Few small entities would be affected by these regulations. A regulatory flexibility analysis, therefore, is not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6). The collection of information contained in these regulations has been submitted to the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act of 1980. These requirements have been approved by OMB.

* * * * *

Amendments to the regulations

Accordingly, 26 CFR Part 1 and Part 602 are amended as follows:

INCOME TAX REGULATIONS

Paragraph 1. The authority citation for Part 1 is amended by adding the following citations: (citations before *** indicate general rulemaking authority).

Authority: 26 U.S.C. 7805 *** Sections 1.897-5T, 1.897-6T and 1.897-7T also issued under 26 U.S.C. 897(d), (e), (g) and (j) and 26 U.S.C. 367(e)(2) *** section 1.1445-10T also issued under 26 U.S.C. 1445(e)(6).

Par. 2. Section 1.897-1 is amended by removing paragraphs (c)(2)(iii)(B), and (n) effective on June 6, 1988, by removing the first, second, fifth and sixth sentences of paragraph (k), effective on June 6, 1988, and by removing the third and fourth sentences of paragraph (k), effective July 1, 1986. Paragraphs (c)(2)(iii)(B), (k), and (n) are hereby reserved.

Par. 3. The following new sections are added immediately after §1.897-4:

§1.897-4AT Table of contents (Temporary).

§1.897-5T Corporate distributions (Temporary).

- (a) Purpose and scope.
- (b) Distributions by domestic corporations.
  - (1) Limitation of basis upon dividend distribution of U.S. real property interest.
  - (2) Distributions by U.S. real property holding corporation under generally applicable rules.
  - (3) Section 332 liquidations of U.S. real property holding corporations.
    - (i) General rules.
    - (ii) Distribution to a foreign corporation under section 332 after June 18, 1980, and before the repeal of the General Utilities doctrine.
    - (iii) Distribution to a foreign corporation under section 332 and former section 334(b)(2) after June 18, 1980.
    - (iv) Distribution to a foreign corporation under section 332(a) after July 31, 1986 and after the repeal of the General Utilities doctrine.
      - (A) Liquidation of domestic corporation.
      - (B) Liquidation of certain foreign corporations making a section 897(i) election.
    - (v) Transfer of foreign corporation stock followed by a section 332 liquidation treated as a reorganization.
  - (4) Section 897(i) companies.
  - (5) Examples.
  - (6) Section 333 elections.
    - (i) General rule.
    - (ii) Example.
- (c) Distributions of U.S. real property interests by foreign corporations.
  - (1) Recognition of gain required.
  - (2) Recognition of gain not required.
    - (i) Statutory exception.
    - (ii) Section 332 liquidations.
      - (A) In general.
      - (B) Recognition of gain required in certain section 332 liquidations.
    - (iii) Examples.
  - (3) Limitation of gain recognized under paragraph (c)(1) of this section for certain section 355 distributions.
    - (i) In general.
    - (ii) Example.
  - (4) Distribution by a foreign corporation in certain reorganizations.
    - (i) In general.
    - (ii) Statutory exception.
    - (iii) Regulatory limitation on gain recognized.
    - (iv) Examples.
  - (5) Sales of U.S. real property interests by foreign corporations under section 337.
  - (6) Section 897(l) credit.
  - (7) Other applicable rules.
- (d) Rules of general application.
  - (1) Interests subject to taxation upon later dispositions.
    - (i) In general.
    - (ii) Effects of income tax treaties.
      - (A) Effect of treaty exemption from tax.
      - (B) Effect of treaty reduction of tax.
      - (C) Waiver of treaty benefits to preserve nonrecognition.
    - (iii) Procedural requirements.
  - (2) Treaty exception to imposition of tax.
  - (3) Withholding.
  - (4) Effect on earnings and profits.
- (e) Effective date.

§1.897-6T Nonrecognition exchanges applicable to corporations their shareholders, and other taxpayers, and certain transfers of property in corporate reorganizations (Temporary).

- (a) Nonrecognition exchanges.
  - (1) In general.
  - (2) Definition of nonrecognition provision.
  - (3) Consequence of nonapplication of nonrecognition provisions.
  - (4) Section 355 distributions treated as exchanges.
  - (5) Section 10[illegible]4 rollover of gain.
    - (i) Purchase of foreign principal residence.
    - (ii) Purchase of U.S. principal residence.
  - (6) Determination of basis.
  - (7) Examples.
  - (8) Treatment of nonqualifying property.
    - (i) In general.
    - (ii) Treatment of mixed exchanges.
      - (A) Allocation of nonqualifying property.
      - (B) Recognition of gain.
      - (C) Treatment of other amounts.
    - (iii) Example.
  - (9) Treaty exception to imposition of tax.
- (b) Certain foreign to foreign exchanges.
  - (1) Exceptions to the general rule.
  - (2) Applicability of exception.
  - (3) No exceptions.
  - (4) Examples.
  - (5) Contribution of property.
- (c) Denial of nonrecognition with respect to certain tax avoidance transfers.
  - (1) In general.
  - (2) Certain transfers to domestic corporations.
    - (i) General rule.
    - (ii) Example.
  - (3) Basis adjustment for certain related person transactions.
  - (4) Rearrangement of ownership to gain treaty benefit.
- (d) Effective date.

§1.897-7T Treatment of certain partnership interests as entirely U.S. real property interests under section 897(g) (Temporary).

- (a) Rule.
- (b) Effective date.

§1.897-8T Status as a U.S. real property holding corporation as a condition for electing section 897(i) pursuant to §1.897-3 (Temporary).

- (a) Purpose and scope.
- (b) General conditions.
- (c) Effective date.

§1.897-9T Treatment of certain interests in publicly traded corporations, definition of foreign person, and

foreign governments and international organizations (Temporary).
(a) Purpose and scope.
(b)
(c) Foreign Person.
(d) Regularly traded.
(e) Foreign governments and international organizations.
(f) Effective date.

§1.897-5T Corporate distributions (Temporary).

(a) *Purpose and scope.* This section provides rules concerning the recognition of gain or loss and adjustments to basis required with request to certain corporate distributions that are subject to section 897. Paragraph (b) of this section provides rules concerning such distributions by domestic corporations, including distributions under section 301, distributions in redemption of stock, and distributions in liquidation. Paragraph (c) sets forth rules concerning distributions by foreign corporations, including distributions under sections 301 and 355, distributions in redemption of stock, and distributions in liquidation. Finally, various rules generally applicable to distributions subject to this section, as well as to transfers subject to §1.897-6T, are set forth in paragraph (d). The rules contained in this section are also subject to the tax avoidance rules of §1.897-6T (c).

(b) *Distributions by domestic corporations*—(1) *Limitation of basis upon dividend distribution of U.S. real property interest.* Under section 897(f), if any domestic corporation (distributing corporation) distributes a U.S. real property interest to a shareholder that is a foreign person (distributee) in a distribution to which section 301 applies, then the basis of the distributed U.S. real property interest in the hands of the foreign distributee shall be determined in accordance with the provisions of section 301(d), and shall not exceed—

(i) The adjusted basis of the property before the distribution in the hands of the distributing corporation, increased by

(ii) The sum of—

(A) Any gain recognized by the distributing corporation on the distribution, and

(B) Any U.S. tax paid by or on behalf of the distributee with respect to the distribution.

(2) *Distributions by U.S. real property holding corporations which are taxable exchanges of stock under generally applicable rules.* If a domestic corporation, stock in which is treated as a U.S. real property interest, distributes property with respect to such stock to a foreign shareholder, the distributee shall be treated as having disposed of a U.S. real property interest, and shall recognize gain or loss on the stock of such domestic corporation to the extent that, with respect to the distributees—

(i) Part or all of the distribution is treated pursuant to section 301(c)(3)(A) as a sale or exchange of stock;

(ii) Part or all of the distribution is treated pursuant to section 302(a) as made in part or full payment in exchange for stock; or

(iii) Part or all of the distribution is treated pursuant to section 331(a) as made in full payment in exchange for stock.

Stock in a domestic corporation shall not be considered a U.S. real property interest pursuant to the provisions of §1.897-2(f)(2) if the corporation does not hold any U.S. real property interests and has disposed of all of its U.S. real property interests owned within the previous five years in transactions in which the full amount of gain was recognized under the rules of §1.897-2(f)(2). If gain is recognized at the corporate level on either a distribution of a U.S. real property interest or a sale of a U.S. real property interest in a liquidation, such distribution or sale shall be considered a disposition for purposes of §1.897-2(f)(2). With regard to the consequences of a distribution from a U.S. real property holding corporation under section 355(a), see §1.897-6T(a)(1) and (4).

(3) *Section 332 liquidations of U.S. real property holding corporations*—(i) *General rules.* Exchanges that are subject to section 897(e) are normally covered by §1.897-6T(a)(1), (2) and (3). This paragraph (b)(3) provides rules concerning the application of section 897(e) and the general principles of §1.897-6T(a)(1), (2) and (3) to section 332 liquidations of U.S. real property holding corporations.

(ii) *Distribution to a foreign corporation under section 332 after June 18, 1980, and before the repeal of the General Utilities doctrine.* Except for distributions under paragraph (b)(3)(iii) of this section (relating to section 332 and former section 334(b)(2)), the rules of this paragraph (b)(3)(ii) shall apply to section 332 distributions after June 18, 1980, and before January 1, 1990, pursuant to section 336(a) as in effect prior to the effective dates of the amendments made by section 631 of the Tax Reform Act of 1986. A foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in a domestic corporation that is a U.S. real property interest shall not, after December 31, 1984, be subject to taxation by reason of section 367(a). The foreign corporation shall recognize gain pursuant to section 897(e)(1) on such stock upon the receipt of property in a section 332(a) liquidation from such domestic corporation, but only to the extent that the property received constitutes property other than a U.S. real property interest. The gain on the stock in the domestic corporation to be recognized by the foreign corporation pursuant to section 897(e)(1) shall be determined by multiplying the gain realized on the distribution by a fraction. The numerator of the fraction shall be the fair market value of the property other than U.S. real property interests received by the foreign corporation on the distribution, and the denominator shall be the fair market value of all property received by the foreign corporation on the distribution. The bases of the distributed U.S. real property interests in the hands of the foreign corporation shall be the same as the bases in the hands of the domestic corporation. The bases of the property other than U.S. real property interests in the hands of the foreign corporation shall be the same as the bases in the hands of the domestic corporation, plus any gain recognized by the foreign corporation on the distribution allocated among such assets in proportion to the potential gain inherent in each such asset at the time of distribution. However, the basis of each asset is limited to its fair market value. Property, other than a U.S. real property interest that is distributed by the domestic corporation, shall not be considered to be distributed by the domestic corporation pursuant to a section 332 liquidation (that is, the foreign corporation shall not be considered to be a corporation for purposes of section 332) if the requirements of section 367(a) are not satisfied. *See*, for example, sections 1245(b)(3) and 1250(d)(3) regarding the consequences to the distributing domestic corporation if the requirements of section 367(a) are not satisfied.

(iii) *Distribution to a foreign corporation under section 332 and former section 334(b)(2) after June 18, 1980.* The rules of this paragraph (b)(2)(iii) shall apply to section 332 distributions after June 18, 1980 where the basis of the distributed property in the hands of the foreign corporation is determined under section 334(b)(2) as in effect prior to the Tax Equity and Fiscal Responsibility Act of 1982. A foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in a domestic corporation that is a U.S. real property interest shall recognize gain on the receipt of property in a section 332(a) liquidation where section 334(b)(2) applies to the extent that the fair market value of the distributed assets that are not U.S. real property interests exceeds the basis of such assets determined under section 334(b)(2) (for example, if the liquidation does not occur immediately upon the purchase of stock in the domestic corporation). The gain recognized shall not exceed the excess of the fair market value of the stock of the domestic corporation in the hands of the foreign corporation at the time of the distribution over the shareholder's adjusted basis in such stock. The basis of the distributed U.S. real property interests in the hands of the foreign corporation shall be determined under section 334(b)(2), by reference to the adjusted basis of the stock with respect to which the distribution was made. The basis of such property other than U.S. real property interests shall be tentatively determined under section 334(b)(2), and then increased by any gain recognized by the foreign corporation on the distribution allocated among such assets in proportion to the potential gain inherent in each such asset at the time of distribution (computed using the tentative basis as determined under section 334(b)(2)). The basis of each asset is limited, however, to its fair market value.

(iv) *Distribution to a foreign corporation under section 332 after July 31, 1986 and after the repeal of the General Utilities doctrine.* The rules of this subdivision (iv) shall apply to section 332 distributions after July 31, 1986, pursuant to section 337(a) as in effect after the effective dates of the amendments of section 631 of the Tax Reform Act of 1986.

(A) *Liquidation of domestic corporation.* A foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in a domestic corporation that is a U.S. real property interest (except a foreign corporation that has made an effective election under section 897(i) and the stock of which is treated as a U.S. real property interest) shall not recognize any gain under sections 367(a) or 897(e)(1) on the receipt of property in a section 332(a) liquidation. The domestic corporation shall not recognize gain under section 367(e)(2) on the distribution of U.S. real property interests (other than stock in a former U.S. real property holding corporation which is treated as a U.S. real property interest) to the foreign corporation. The domestic corporation shall recognize gain under section 367(e)(2) on the distribution of stock in a former U.S. real property holding corporation which is treated as U.S. real property interest. With respect to the recognition of gain or loss by the domestic corporation under section 367(e)(2) on the distribution of property other than U.S. real property interests, see the regulations under section 367(e)(2). The basis of the distributed U.S. real property interests (other than stock in a former U.S. real property holding corporation) in the hands of the foreign corporation shall be the same as it was in the hands of the domestic corporation. The basis of any property (other than U.S. real property interests) and stock in a former U.S. real property holding corporation that is a U.S. real property interest in the hands of the foreign corporation shall be the same as it was in the hands of the domestic corporation increased by any gain recognized by the distributing corporation on the distribution that was subject to U.S. taxation.

(B) *Liquidation of certain foreign corporations making a section 897(i) election.* A foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in another foreign corporation, that has made an effective election under section 897(i) and the stock of which is treated as a U.S. real property interest, shall recognize gain pursuant to section 897(e)(1) on such stock upon the receipt from the distributing foreign corporation of property that is not a U.S. real property interest, and that is not used by the distributee foreign corporation in the conduct of a trade or business within the United States (if the distibutee foreign corporation is not a resident of a country with which the United States maintains an income tax treaty) or in a permanent establishment within the United States (if the distributee foreign corporation is a resident of a country with which the United States maintains an income tax treaty). The gain on the stock in the foreign corporation (making an effective election under section 897(i)) to be recognized by the distributee foreign corporation pursuant to section 897(e)(1) shall be determined by multiplying the gain realized on the distribution by a fraction. The numerator of the fraction shall be the fair market value of the property received by the distributee foreign corporation upon which it must recognize gain, and the denominator of the fraction shall be the fair market value of all property received by the distributee foreign corporation on the distribution. The distributing foreign corporation shall not recognize gain under section 367(e)(2) on the distribution of U.S. real property interests to the distributee foreign corporation. With respect to the recognition of gain or loss under section 367(e)(2) on the distribution of property other than U.S. real property interests, see the regulations under section 367(e)(2). The basis of the distributed U.S. real property interests in the hands of the distributee foreign corporation shall be the same as it was in the hands of the distributing foreign corporation. The basis of the property upon which the distributee foreign corporation recognized gain in the hands of the distributee foreign corporation shall be the same as the basis in the hands of the distributing foreign corporation, plus any gain recognized by the distributee foreign corporation on the receipt of such property allocated among such property in proportion to the potential gain inherent in each such property at the time of the distribution. In regard to the basis of any other property received by the distributee foreign corporation in the liquidation, see the regulations under section 367(e)(2). However, the basis of each asset is limited to its fair market value.

(v) *Transfer of foreign corporation stock followed by a section 332 liquidation treated as a reorganization.* If a nonresident alien or foreign corporation transfers the stock of a foreign corporation that owns a U.S. real property interest to a domestic corporation in exchange for stock of the domestic corporation (or its domestic or foreign parent corporation) in a reorganization under section 368(a)(1)(B) or in an exchange under section 351(a), and if the foreign corporation then distributes the U.S. real property interest to the domestic corporation in a liquidation described in section 332(a) within five years of the transfer of the stock of the foreign corporation to the domestic corporation, then the transfer of the foreign corporation stock and the liquidation shall be treated as a reorganization described in section 368(a)(1)(C) or (D). The rules of §1.897-6T(a)(1) shall apply to the transfer of the U.S. real property interest to the domestic corporation in exchange for domestic corporation stock, and the rules of §1.897-5T(c)(4) shall apply to the distribution of domestic corporation stock by the foreign corporation. However, the rules of this paragraph (b)(3)(v) shall not apply if the transfer of the foreign corporation stock and the liquidation under section 332(a) are separate and independent transactions justified by substantial and verifiable business purposes.

(4) *Section 897(i) companies.* Except as otherwise provided herein for purposes of this section and §1.897-6T, a foreign corporation that has made a valid election under section 897(i) shall be treated as a domestic corporation and not as a foreign corporation in determining the application of section 897. For rules concerning the making of a section 897(i) election, see §§1.897-3 and 1.897-8T. In regard to section 367(e)(2) and foreign corporations that have made an effective election under section 897(i), see paragraph (b)(3)(iv) of this section.

(5) *Examples.* The following examples illustrate the rules of this paragraph (b). In each example there is no applicable income tax treaty to which the United States is a party.

Example (1). (i) A is a nonresident alien who owns 100 percent of the stock of DC, a U.S. real property holding corporation. DC's only asset is Parcel P, a U.S. real property interest, with a fair market value of $500,000 and an adjusted basis of $300,000. DC completely liquidates in 1987 and distributes Parcel P to A in exchange for the DC stock held by A.

(ii) Under section 336(a), DC must recognize gain to the extent of the excess of the fair market value ($500,000) over the adjusted basis ($300,000), or $200,000.

(iii) A does not recognize any gain under section 897(a) because the DC stock in the hands of A is no longer a U.S. real property interest under paragraph (b)(2) of this section and paragraph 2(f) of §1.897-2. A does recognize gain (if any) under section 331(a); however, the gain is not subject to taxation under section 871(a). A's adjusted basis in Parcel P is $500,000.

(iv) If DC did not recognize all of the gain on the disposition under a transitional rule to section 631 of the Tax Reform Act of 1986, then paragraph (b)(2) of this section and paragraph 2(f) of §1.897-2 would not apply to A. A would recognize gain (if any) under paragraph (b)(2) because the distribution is treated as in full payment in exchange for the DC stock under section 897(a).

Example (2). (i) FC, a Country F corporation, owns 100 percent of the stock of DC, a U.S. real property holding corporation. FC's basis in the stock of DC is $400,000, and the fair market value of the DC stock is $800,000. DC owns a U.S. real property interest with an adjusted basis of $350,000 and a fair market value of $600,000. DC also owns other assets that are not U.S. real property interests that have an adjusted basis of $125,000 and a fair market value of $200,000. DC completely liquidates in 1985 and distributes all of its property to FC in exchange for the DC stock held by FC.

(ii) Under paragraph (b)(3)(ii) of this section, FC recognizes $100,000 of gain under section 897(a) on the disposition of the DC stock. This is determined by multiplying FC's gain realized ($400,000) by a fraction. The numerator of the fraction is the fair market value of the property other than U.S. real property interests ($200,000), and the denominator of the fraction is the fair market value of all property received ($800,000). FC takes a carryover adjusted basis in the U.S. real property interest ($350,000). FC's adjusted basis in the assets that are not U.S. real property interests ($200,000) is the basis of those assets in the hands of DC ($125,000) plus the gain recognized by FC on the distribution ($100,000) not to exceed the fair market value ($200,000).

Example (3). (i) FC, a Country F corporation, owns 100 percent of the stock of DC, a U.S. real property holding corporation. DC's basis in the stock of DC is $300,000, and the fair market value of the DC stock is $500,000. DC owns Parcel P, a U.S. real property interest, with an adjusted basis of $250,000 and a fair market value of $400,000. DC also owns all of the stock of DX, a former U.S. real property holding corporation whose stock is a U.S. real property interest, with an adjusted basis of $50,000 and a fair market value of $100,000. DC completely liquidates in 1987 and distributes all of its property to FC in exchange for the DC stock held by FC.

(ii) Under paragraph (b)(3)(iv)(A) of this section, DC recognizes $50,000 of gain on the distribution to FC of the DX stock. DC does not recognize any gain for purposes of section 367(e)(2) on the distribution to FC of Parcel P.

(iii) Under paragraph (b)(3)(iv)(A) of this section, FC's disposition of its DC stock is not treated as a disposition of a U.S. real property interest. Under section 334(b)(1), FC takes a carryover adjusted basis of $250,000 in Parcel P. FC takes an increased basis of $100,000 in the DX stock which is equal to DC's basis ($50,000) increased by the gain recognized by DC ($50,000).

(iv) The result would be the same if FC had made an effective election under section 897(i).

(6) *Section 333 elections*—(i) *General rule.* A foreign shareholder that elects section 333 as in effect prior to its repeal by the Tax Reform Act of 1986 upon the distribution of property in a liquidation by a domestic corporation whose stock is treated as a U.S. real property interest shall recognize

gain on such stock to the extent that—

(A) The property received by the foreign shareholder constitutes property other than U.S. real property interests subject to U.S. taxation upon its disposition as specified by paragraph (a)(1) of this section, or

(B) The basis of a U.S. real property interest subject to U.S. taxation upon its disposition in the hands of the recipient foreign shareholder exceeds the basis of the U.S. real property interest in the hands of the liquidating domestic corporation.

In determining the amount of gain recognized by the foreign shareholder, the foreign shareholder shall be considered to have exchanged the domestic corporation stock for all the property distributed on a proportionate fair market value basis. The gain recognized on a respective portion of domestic corporation stock shall not exceed the gain realized on that portion. Property other than U.S. real property interests subject to U.S. taxation upon disposition shall have a fair market value basis in the hands of the foreign shareholder. The basis of U.S. real property interests subject to U.S. taxation upon disposition shall be the basis of the proportionate part of the domestic corporation stock cancelled or redeemed in the liquidation, increased in the amount of gain recognized (other than gain recognized under this section) by the shareholder in respect to that proportionate part of the domestic corporation stock.

(ii) *Example.* The rules of paragraph (b)(6)(i) of this section may be illustrated by the following example.

Example. (i) A is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. A owns all of the stock of DC, a U.S. real property holding corporation. The DC stock has a fair market value of $1,000,000. A acquired the DC stock in two purchases. The basis of one lot of the DC stock is $150,000, and the basis of the other lot is $650,000.

(ii) DC owns Parcel P, a U.S. real property interest, with a fair market value of $750,000 and an adjusted basis of $400,000. DC's only other property is equipment with a fair market value of $250,000 and an adjusted basis of $100,000. DC does not have any earnings and profits.

(iii) DC completely liquidates in 1985 in accordance with section 333 by distributing Parcel P and the equipment to A. A elects section 333 treatment.

(iv) A is considered as having exchanged 75 percent (fair market value of Parcel P/fair market value of all property distributed) of the DC stock for Parcel P. A realized gain of $150,000 on that portion of the DC stock ($750,000 − $600,000). All of the gain of $150,000 is recognized under section 897(a) because A's basis in Parcel P under section 334(c) ($600,000) would exceed DC's basis in Parcel P ($400,000) by at least the amount of realized gain. A takes a basis of $750,000 in Parcel P.

(v) A is considered as having exchanged 25 percent (fair market value of equipment/fair market value of all property distributed) of the DC stock for the equipment. A realized gain of $50,000 on that portion of the DC stock ($250,000 − $200,000). All of the gain of $50,000 is recognized under section 897(a). A takes a basis of $250,000 in the equipment.

(c) *Distributions of U.S. real property interests by foreign corporations*—(1) *Recognition of gain required.* If a foreign corporation makes a distribution (including a distribution in liquidation or redemption) of a U.S. real property interest to a shareholder (whether foreign or domestic), then, except as provided in paragraph (c)(2), (3) or (4) of this section, the distributing corporation shall recognize gain (but not loss) on the distribution under section 897(d)(1). The gain recognized shall be equal to the excess of the fair market value of the U.S. real property interest (as of the time of the distribution) over its adjusted basis. Except as otherwise provided, the distributee's basis in the distributed U.S. real property interest shall be determined under the otherwise applicable sections of the Code. The distributee (whether domestic or foreign) of a foreign corporation in a liquidation under section 332 shall take the foreign corporation's basis in the distributed U.S. real property interest increased by any gain recognized (and subject to U.S. income taxation) by the foreign corporation on the distribution of such U.S. real property interest.

(2) *Recognition of gain not required*—(i) *Statutory exception rule.* Under section 897(d)(2)(A), gain shall not be recognized by a distributing foreign corporation if—

(A) At the time of the receipt of the distributed U.S. real property interest, the distributee would be subject to U.S. income taxation on a subsequent disposition of the U.S. real property interest, determined in accordance with the rules of paragraph (d)(1) of this section;

(B) The basis of the distributed U.S. real property interest in the hands of the distributee is not greater than the adjusted basis of such property before the distribution, increased by the amount of gain (if any) recognized by the distributing corporation upon the distribution and added to the adjusted basis under the otherwise applicable provisions; and

(C) The distributing corporation complies with the filing requirements of paragraph (d)(1)(iii) of this section.

(ii) *Section 332 liquidations*—(A) *In general.* A distributing foreign corporation that meets the requirements of paragraph (c)(2)(i) in a section 332(a) liquidation shall not recognize gain on the distribution of U.S. real property interests to a foreign corporation meeting the stock ownership requirements of section 332(b) if the distributing corporation complies with the procedural requirements of paragraph (d)(1)(iii). Whether a foreign corporation recognizes gain on the distribution of U.S. real property interests to a U.S. corporation meeting the stock ownership requirements of section 332(b) depends upon whether the U.S. corporation satisfies the subject to tax requirement provided in paragraph (d)(1)(i) (in addition to the procedural requirements of paragraph (d)(1)(iii)). With respect to section 332 distributions by a foreign corporation occurring after July 31, 1986, section 367(e)(2) shall not affect the application of section 337(a) (as in effect after the Tax Reform Act of 1986) and paragraph (c)(2)(i) of this section to the distribution of a U.S. real property interest.

(B) *Recognition of gain required in certain section 332 liquidations.* Notwithstanding the other rules of this paragraph (c), a foreign corporation shall, pursuant to the authority conferred by section 897(e)(2), recognize gain on its distribution after May 5, 1988 of a U.S. real property interest to a domestic corporation meeting the

best copy available

stock ownership requirements of section 332(b) if—

(*1*) the foreign corporation has not made an election under section 897(i), and any gain on the stock in the foreign corporation would be subject to U.S. taxation if an election were made on the date of the liquidation; and

(*2*) The distribution of the U.S. real property interest by the foreign corporation to the domestic corporation pursuant to section 332(a) occurs less than five years after the date of the last gain from the disposition of stock of the foreign corporation that would be subject to payment of tax under section 1.897-3(d)(2)(i) if an election under section 897(i) were made by the foreign corporation on the date of its liquidation. With regard to the treatment of certain foreign corporations as domestic corporations under section 897(i), however, see §§1.897-3 and 1.897-8T.

(iii) *Examples.* The rules of this paragraph (c)(2) may be illustrated by the following examples.

Example (1). (i) DC, a domestic corporation, owns 100 percent of the stock of FC, a Country F corporation. FC's only asset is Parcel P, a U.S. real property interest, with a fair market value of $500x and an adjusted basis of $100x. In September 1987, FC liquidates under section 332(a) and transfers Parcel P to DC. The transitional rules contained in section 633 of the Tax Reform Act of 1986 concerning the repeal of the *General Utilities* doctrine would not be applicable to a subsequent distribution or disposition of assets by DC.

(ii) Assume that FC complies with the filing requirements of paragraph (d)(1)(iii). DC will be subject to U.S. income taxation on a subsequent disposition of Parcel P under the rules of paragraph (d)(1). The basis of Parcel P in the hands of DC will be $100x under section 334(b)(1), and thus no greater than the basis of Parcel P in the hands of FC. FC does not recognize any gain under the rules of paragraph (c)(1) of this section on the distribution because the exception of paragraph (d)(2)(i) applies.

Example (2). If in *Example* (1) the distribution by FC to DC occurred in September 1985, and DC sold or exchanged Parcel P under sections 336(a) or 337(a) as in effect prior to the Tax Reform Act of 1986, then FC must recognize gain of $400x on the distribution of Parcel P. The gain must be recognized because Parcel P in the hands of DC is not considered subject to U.S. income taxation on a subsequent disposition under the rules of paragraph (d)(1) of this section.

(3) *Limitation of gain recognized under paragraph (c)(1) of this section for certain section 355 distributions*—(i) *In general.* Under paragraph (c)(1) of this section, a foreign corporation that distributes stock in a domestic corporation that constitutes a U.S. real property interest in a distribution to which section 355 applies shall recognize gain on the distribution to the extent that the fair market value of the distributed stock exceeds its adjusted basis in the hands of the distributing foreign corporation. The gain recognized shall be limited under this paragraph (c)(3), however, to the amount by which the aggregate basis of the distributed stock in the hands of the distributees exceeds the aggregate adjusted basis of the distributed stock in the hands of the distributing corporation. The distributees' basis in the distributed U.S. real property interest shall be determined under the otherwise applicable provisions of section 358. (Thus, the distributees' basis in the distributed U.S. real property interest shall be determined without any increase for any gain recognized by the foreign corporation).

(ii) *Example.* The rules of paragraph (c)(3)(i) of this section may be illustrated by the following example.

Example. (i) C is a citizen and resident of Country F. C owns all of the stock of FC, a Country F corporation. The fair market value of the FC stock is 1000x, and C has a basis of 600x in the FC stock. Country F does not have an income tax treaty with the United States.

(ii) In a transaction qualifying as a distribution of stock of a controlled corporation under section 355(a), FC distributes to C all of the stock of DC, a U.S. real property holding corporation. C does not surrender any of the FC stock. The DC stock has a fair market value of 600x, and FC has an adjusted basis of 200x in the DC stock. After the distribution, the FC stock has a fair market value of 400x.

(iii) Under paragraph (c)(3)(i) of this section, FC must recognize gain on the distribution of the DC stock to C equal to the difference between the fair market value of the DC stock (600x) and FC's adjusted basis in the DC stock (200x). This results in a potential gain of 400x. Under section 358, C takes a 360x adjusted basis in the DC stock. Provided that FC complies with the filing requirements of paragraph (d)(1)(iii) of this section, the gain recognized by FC is limited under paragraph (c)(3)(i) to 160x because (A) this is the amount by which the basis of the DC stock in the hands of C (360x) exceeds the adjusted basis of the DC stock in the hands of FC (200x), and (B) at the time of receipt of the DC stock, C would be subject to U.S. taxation on a subsequent disposition of the stock.

(iv) C's adjusted basis in the DC stock is not increased by the 160x recognized by FC.

(4) *Distribution by a foreign corporation in certain reorganizations*—(i) *In general.* Under paragraph (c)(1) of this section, a foreign corporation that transfers property to another corporation in an exchange under section 361(a) for stock of a domestic corporation which is a United States real property holding corporation immediately after the transfer in a reorganization under section 368(a)(1)(C), (D) or (F) shall recognize gain under section 897(d)(1) on the distribution (whether actual or deemed) of the stock of the domestic corporation received by the foreign corporation to its shareholders (whether domestic or foreign). See §1.897-6T(a) of the regulations for the consequences to the foreign corporation of the exchange of its property for the domestic corporation stock.

(ii) *Statutory exception.* Pursuant to the exception provided in section 897(d)(2)(A), no gain shall be recognized by the foreign corporation on its distribution of the domestic corporation stock if—

(A) At the time of the distribution, the distributee (*i.e.*, the exchanging shareholder in the section 354 exchange) would be subject to U.S. taxation on a subsequent disposition of the stock of the domestic corporation, determined in accordance with the rules of paragraph (d)(1) of this section;

(B) The distributee's adjusted basis in the stock of the foreign corporation immediately before the distribution was no greater than the foreign corporation's basis in the stock of the domestic corporation determined under section 358; and

(C) The distributing corporation complies with the filing requirements of paragraph (d)(1)(iii) of this section.

(iii) *Regulatory limitation on gain recognized.* If the requirements of subdivisions (A) and (C) of paragraph (c)(4)(ii) are met, the amount of any gain recognized by the foreign corporation shall not exceed the excess of the distributee's basis in the stock of the foreign corporation immediately before the distribution over the foreign corporation's basis in the stock of the domestic corporation immediately before the distribution as determined under section 358.

(iv) *Examples.* The rules of paragraph (c)(4) of this section may be illustrated by the following examples.

Example (1). (i) A, a nonresident alien, organized FC, a Country W corporation, in September 1980 to invest in U.S. real estate. In 1986, FC's only asset is Parcel P, a U.S. real property interest with a fair market value of $600,000 and an adjusted basis to FC of $200,000. Parcel P is subject to a mortgage with an outstanding balance of $100,000. The fair market value of the FC stock is $500,000, and A's adjusted basis in the stock is $100,000. FC does not have liabilities in excess of the adjusted basis in Parcel P. The United States does not have a treaty with Country W that entitles FC to nondiscriminatory treatment as described in section 1.897-3(b)(2) of the regulations.

(ii) Pursuant to a plan of reorganization under section 368(a)(1)(D), FC transfers Parcel P to DC, a newly formed domestic corporation, in exchange for DC stock. FC distributes the DC stock to A in exchange for A's FC stock.

(iii) FC's exchange of Parcel P for the DC stock is a disposition of a U.S. real property interest. Under §1.897-6T(a)(1), there is an exchange of a U.S. real property interest (Parcel P) for another U.S. real property interest (DC stock) so that no gain is recognized on the exchange under section 897(e). DC takes FC's basis of $200,000 in Parcel P under section 362(b). Under section 358(a)(1), FC takes a $100,000 basis in the DC stock because FC's substituted basis of $200,000 in the DC stock is reduced by the $100,000 of liabilities to which Parcel P is subject.

(iv) Under section 897(d)(1) and paragraph (c)(4)(i) of this section, FC generally must recognize gain on the distribution of the DC stock received in exchange for FC's assets equal to the difference between the fair market value of the DC stock ($500,000) and FC's adjusted basis in the DC stock prior to the distribution ($100,000). This results in a potential gain of $400,000. Under section 358(a)(1), A takes a basis in the DC stock equal to the basis in the FC stock of $100,000. Provided that FC complies with the filing requirements of paragraph (d)(1)(iii) of this section, no gain is recognized by FC on the distribution of the DC stock under the statutory exception to the general rule of section 897(d)(1) provided in section 897(d)(2)(A) and paragraph (c)(4)(ii) of this section because (*1*) A's basis in the DC stock ($100,000) does not exceed FC's adjusted basis in the DC stock ($100,000) immediately prior to the distribution and (*2*) A, at the time of receipt of the DC stock, would be subject to U.S. taxation on a subsequent disposition of the stock.

(v) The FC stock in the hands of A is not a U.S. real property interest because FC is a foreign corporation that has not elected to be treated as a domestic corporation under section 897(i). Accordingly, the exchange of the FC stock by A for DC stock is not a disposition of a U.S. real property interest under section 897(a).

Example (2). The facts are the same as in Example (1), except that A purchased the FC stock in September 1983 for $100,000 from S, a nonresident alien, and that S had a basis of $40,000 in the FC stock at the time of the sale to A. The results are the same as in Example 1.

Example (3). (i) The facts are the same as in *Example* 1, except that A's adjusted basis in the FC stock prior to the reorganization is $300,000. Following the distribution, A takes its basis of $300,000 in the FC stock as its basis in the DC stock pursuant to section 358(a)(1).

(ii) FC does not qualify under the statutory exception of paragraph (c)(4)(ii) to the general recognition rule of section 897(d)(1) and paragraph (c)(4)(i) of this section because A's basis in the DC stock ($300,000) exceeds FC's adjusted basis in the DC stock ($100,000) immediately prior to the distribution. However, provided that FC complies with the filing requirements of paragraph (d)(1)(iii) of this section, the gain recognized by FC is limited to $200,000 under the regulatory limitation of gain provided by paragraph (c)(4)(iii). This is the excess of A's basis in the FC stock immediately before the distribution ($300,000) over A's adjusted basis in the DC stock immediately before the distribution ($100,000).

(iii) A takes a basis of $300,000 in the DC stock under section 358(a)(1). A's basis in the DC stock is not increased by the gain recognized by FC. DC takes a basis of $200,000 in Parcel P under section 362(b).

Example (4). (i) The facts are the same as in *Example* (3), except that the United States has an income tax treaty with Country W entitling FC to nondiscriminatory treatment under section 1.897-3(b)(2) of the regulations. A valid election under section 897(i) is made to treat FC as a U.S. corporation.

(ii) FC is treated as a domestic corporation for purposes of section 897 and is not required to recognize gain under section 897(d)(1) and paragraph (c)(4)(i) of this section on the distribution of the DC stock as described in *Example* (3) (If a valid section 897(i) election were not made, the result would be same as in *Example* (3).)

(iii) The FC stock in the hands of A is a U.S. real property interest because an election was made under section 897(i) to treat FC as a U.S. corporation. The exchange of the FC stock for DC stock by A is a disposition of a U.S. real property interest. Under section 897(e)(1) and paragraph (a) of §1.897-6T, A does not recognize gain on the exchange because there is an exchange of a U.S. real property interest (the FC stock) for another U.S. real property interest (the DC stock). Under section 358(a)(1), A takes as its basis in the DC stock A's basis in the FC stock ($300,000).

(5) *Sales of U.S. real property interests by foreign corporations under section 337.* Section 337 as in effect prior to the Tax Reform Act of 1986 shall not apply to any sale or exchange (including a deemed section 337 sale pursuant to an election under section 338(a) to treat a stock purchase as an asset acquisition) of a U.S. real property interest by a foreign corporation.

(6) *Section 897(l) credit.* If a foreign corporation adopts a plan of complete liquidation and if, solely by reason of section 897(d) and this section, section 337(a) (as in effect before the Tax Reform Act of 1986) does not apply to sales or exchanges of, or section 336 (as in effect before the Tax Reform Act of 1986) does not apply to distributions of, United States real property interests by the liquidating corporation, then—

(i) The amount realized by the shareholder on the distribution shall be increased by its proportionate share of the amount by which the tax imposed by chapter 1 of the Code, as modified by the provisions of any applicable U.S. income tax treaty, on the liquidating corporation would have been reduced if section 897(d) and this section had not been applicable, and

(ii) For purposes of the Code, the shareholder shall be deemed to have paid, on the last day prescribed by law for the payment of the tax imposed by subtitle A of the Code on the shareholder for the taxable year, an amount of tax equal to the amount of increase in the amount realized described in subdivision (i) of this paragraph (c).

The special rule provided by this paragraph (c)(5) applies only to shareholders who are United States citizens or residents, and who have held stock in the liquidating corporation continuously since June 18, 1980. This special rule also only applies for the first taxable year of any such shareholder in which the shareholder receives a distribution in complete liquidation from the foreign corporation.

(7) *Other applicable rules.* For rules concerning exemption of gain pursuant to a U.S. income tax treaty, withholding of tax from distributions, and other applicable rules, see paragraph (d) of this section. For the treatment of liquidations described in section 334(b)(2)(A) of certain foreign cor-

porations acquired before November 6, 1980, see §1.897-4.

(d) *Rules of general application*—(1) *Interests subject to taxation upon later disposition*—(i) *In general.* Pursuant to the otherwise applicable rules of this section and §1.897-6T, nonrecognition of gain or loss may apply with respect to certain distributions or exchanges of U.S. real property interests if any gain from a subsequent disposition of the interests that are distributed or received by the transferor in the exchange would be included in the gross income of the distributee or transferor and be subject to U.S. taxation. Gain is considered subject to U.S. taxation if the gain is included on the income tax return of a U.S. tax paying entity even if there is no U.S. tax liability (for example, because of net operating losses or an investment tax credit). Gain is not considered subject to U.S. taxation if the gain is derived by a tax exempt entity. A real estate investment trust is considered to be a pass-through entity for purposes of the rule of taxability of this paragraph (d)(1)(i). Thus, for example, a tax exempt entity holding an interest in a real estate investment trust is not subject to tax. A domestic corporation (including a foreign corporation that makes an effective section 897(i) election after receipt of the U.S. real property interest) shall not be considered subject to U.S. taxation on a subsequent disposition of a U.S. real property interest if it received the U.S. real property interest prior to the effective date of the repeal of sections 336(a) or 337(a) as in effect prior to the Tax Reform Act of 1986, unless the U.S. real property interest has not been sold or exchanged by the domestic corporation prior to such effective date in a transaction to which either section 336(a) or section 337(a) (as in effect prior to such effective date) applied. In addition, an interest shall be considered to be subject to U.S. taxation upon its subsequent disposition only if the requirements set forth in subdivision (iii) of this paragraph (d)(1) are met.

(ii) *Effects of income tax treaties*—(A) *Effect of treaty exemption from tax.* Except as otherwise provided in subdivision (C) of this paragraph (d)(1)(ii), a U.S. real property interest shall not be considered to be subject to U.S. taxation upon a subsquent disposition if, at the time of its distribution or exchange, the recipient is entitled pursuant to the provisions of a U.S. income tax treaty to an exemption from U.S. taxation upon a disposition of the interest.

(B) *Effect of treaty reduction of tax.* If, at the time of a distribution or exchange, a distributee of a U.S. real property interest in a distribution or a transferor who receives a U.S. real property interest in an exchange would be entitled pursuant to the provisions of a U.S. income tax treaty to reduced U.S. taxation upon the disposition of the interest, then a portion of the interest received shall be treated as an interest subject to U.S. taxation upon its disposition, and, therefore, that portion shall be entitled to nonrecognition treatment under the rules of this section or §1.897-6T. The portion of the interest that is treated as subject to U.S. taxation is determined by multiplying the fair market value of the interest by a fraction. The numerator of the fraction is the amount of tax that would be due pursuant to the provisions of the applicable U.S. income tax treaty upon the recipient's disposition of the interest, determined as of the date of the distribution or transfer. The denominator of the fraction is the amount of tax that would be due upon such disposition but for the provisions of the treaty. However, nonrecognition treatment may be preserved in accordance with the provisions of subdivision (C) of this paragraph (d)(1)(ii). With regard to the provisions of this paragraph, see Article XIII(9) of the United States-Canada Income Tax Convention.

(C) *Waiver of treaty benefits to preserve nonrecognition.* Notwithstanding the provisions of subdivisions (A) and (B) of this paragraph (d)(1)(ii), an interest shall be considered to be subject to U.S. taxation upon its subsequent disposition if, in accordance with paragraph (d)(1)(iii)(F) of this section, the recipient waives the benefits of a U.S. income tax treaty that would otherwise entitle the recipient to an exemption from (or reduction of) U.S. tax upon a disposition of the interest.

(iii) *Procedural requirements.* If a U.S. real property interest is distributed or transferred after December 31, 1987, the transferor or distributor (that is a nonresident alien individual or a foreign corporation) shall file an income tax return for the taxable year of the distribution or transfer. Also, if a U.S. real property interest is distributed or transferred in a transaction before January 1, 1988, with respect to which nonrecognition treatment would not have been available under the express provisions of section 897(d) or (e) of the Code but is available under the provisions of this section or §1.897-6T, then the person that would otherwise be subject to tax by reason of the operation of section 897 must file an income tax return for the taxable year of the distribution or transfer. This requirement is satisfied by filing a tax return or an amended tax return for the year of the distribution or transfer by May 5, 1989, or by the date that the filing of the return is otherwise required. The person filing the return must attach thereto a document setting forth the following:

(A) A statement that the distribution or transfer is one to which section 897 applies;

(B) A description of the U.S. real property interest distributed or transferred, including its location, its adjusted basis in the hands of the distributor or transferor immediately before the distribution or transfer, and the date of the distribution or transfer;

(C) A description of the U.S. real property interest received in an exchange;

(D) A declaration signed by an officer of the corporation that the distributing foreign corporation has substantiated the adjusted basis of the shareholder in its stock if the distributing corporation has nonrecognition or recognition limitation under paragraph (c)(3) or (4) of this section;

(E) The amount of any gain

recognized and tax withheld by any person with respect to the distribution or transfer;

(F) Identification by name and address of the distributee or transferee, including the distributee's or transferee's taxpayer identification number (if any);

(G) The treaty and article (if any) under which the distributee or transferor would be exempt from U.S. taxation on a sale of the distributed U.S. real property interest or the U.S. real property interest received in the transfer; and

(H) A declaration, signed by the distributee or transferor or its authorized legal representative, that the distributee or transferor shall treat any subsequent sale, exchange, or other disposition of the U.S. real property interest as a disposition that is subject to U.S. taxation, notwithstanding the provisions of any U.S. income tax treaty or intervening change in circumstance.

A person who has provided or filed a notice described in §1.1445-2(d)(2)(iii) or §1.1445-5(b)(2)(ii) in connection with a transaction may satisfy the requirement of this paragraph (d)(1)(iii) by attaching to his return a copy of that notice together with any information or declaration required by this subdivision not contained in that notice.

(2) *Treaty exception to imposition of tax.* If gain that would be currently recognized pursuant to the provisions of this section or §1.897-6T is subject to an exemption from (or reduction of) U.S. tax pursuant to a U.S. income tax treaty, then gain shall be recognized only as provided by that treaty, for dispositions occurring before January 1, 1985. For dispositions occurring after December 31, 1984, all gain shall be recognized as provided in section 897 and the regulations thereunder, except as provided by Articles XIII(9) and XXX(5) of the United States-Canada Income Tax Convention or other income tax treaty entered into force after June 6, 1988. With regard to Article XXX(5) of the Income Tax Treaty with Canada, see, Rev. Rul. 85-76, 1985-1 C.B. 409. With regard to basis adjustments for certain related person transactions, see §1.897-6T(c)(3).

(3) *Withholding.* Under sections 1441 and 1442, as modified by the provisions of any applicable U.S. income tax treaty, a corporation must withhold tax from a dividend distribution to which section 301 applies to a shareholder that is a foreign person, if the dividend is considered to be from sources inside the United States. For a description of dividends that are considered to be from sources inside the United States, see section 861(a)(2). Under section 1445, withholding is required with respect to certain dispositions and distributions of U.S. real property interests.

(4) *Effect on earnings and profits.* With respect to adjustments to earnings and profits for gain recognized to a distributing corporation on a distribution, see section 312 and the regulations thereunder.

(e) *Effective date.* Except as otherwise specifically provided in the text of these regulations, this section shall be effective for transfers, exchanges, distributions and other dispositions occurring after June 18, 1980.

§1.897-6T Nonrecognition exchanges applicable to corporations, their shareholders, and other taxpayers, and certain transfers of property in corporate reorganizations (Temporary).

(a) *Nonrecognition exchanges*—(1) *In general.* Except as otherwise provided in this section and in §1.897-5T, for purposes of section 897(e) any nonrecognition provision shall apply to a transfer by a foreign person of a U.S. real property interest on which gain is realized only to the extent that the transferred U.S. real property interest is exchanged for a U.S. real property interest which, immediately following the exchange, would be subject to U.S. taxation upon its disposition, and the transferor complies with the filing requirements of paragraph (d)(1)(iii) of §1.897-5T. No loss shall be recognized pursuant to section 897(e) or the rules of this section unless such loss is otherwise permitted to be recognized. In the case of an exchange of a U.S. real property interest for stock in a domestic corporation (that is otherwise treated as U.S. real property interest), such stock shall not be considered a U.S. real property interest unless the domestic corporation is a U.S. real property holding corporation immediately after the exchange. Whether an interest would be subject to U.S. taxation in the hands of the transferor upon its disposition shall be determined in accordance with the rules of §1.897-5T(d)(1).

(2) *Definition of "nonrecognition" provision.* A "nonrecognition provision" is any provision of the Code which provides that gain or loss shall not be recognized if the requirements of that provision are met. Nonrecognition provisions relevant to this section include, but are not limited to, sections 332, 351, 354, 355, 361, 721, 731, 1031, 1033, 1034 and 1036. For purposes of section 897(e), sections 121 and 453 are not nonrecognition provisions.

(3) *Consequence of nonapplication of nonrecognition provisions.* If a nonrecognition provision does not apply to a transaction, then the U.S. real property interest transferred shall be considered exchanged pursuant to a transaction that is subject to U.S. taxation by reason of the operation of section 897. See, however, §1.897-5T(d)(2) with respect to the treaty exceptions to the imposition of tax. If a U.S. real property interest is exchanged for an interest the disposition of which is only partially subject to taxation under chapter 1 of the Code (as modified by the provisions of any applicable U.S. income tax treaty), then any nonrecognition provision shall apply only to the extent that the interest received in the exchange would be subject to taxation under chapter 1 of the Code, as modified. For example, the exchange of a U.S. real property interest for an interest in a partnership will receive nonrecognition treatment pursuant to section 721 only to the extent that a disposition of the partnership interest will be subject to U.S. taxation by reason of the operation of section 897(g).

(4) *Section 355 distributions treated as exchanges.* If a domestic

corporation, stock in which is treated as a U.S. real property interest, distributes stock in a foreign corporation or stock in a domestic corporation that is not a U.S. real property holding corporation to a foreign person under section 355(a), then the foreign person shall be considered as having exchanged a proportionate part of the stock in the domestic corporation that is treated as a U.S. real property interest for stock that is not treated as a U.S. real property interest.

(5) *Section 1034 rollover of gain*—(i) *Purchase of foreign principal residence*. A nonresident alien individual shall not be entitled to nonrecognition under section 1034 on the sale of a principal residence when the new principal residence acquired is not a U.S. real property interest.

(ii) *Purchase of U.S. principal residence*. A nonresident alien individual who sells his principal residence that is a U.S. real property interest and, within a period beginning two years before the date of such sale and ending on the date (with extensions) of filing his income tax return for the taxable year of the sale of the principal residence, purchases and uses another U.S. real property interest as a principal residence, shall, to the extent provided by section 1034, not recognize gain on the sale of the principal residence. If the individual has not purchased another U.S. real property interest as a principal residence at the time of the filing of the return for the year of sale, the individual must file a timely income tax return for the year of sale without claiming the benefit of section 1034. If the individual subsequently purchases another U.S. property interest as a principal residence that otherwise qualifies under section 1034 after the due date of the income tax return for the year of the sale of the principal residence and before a date that is two years after the sale of the principal residence, the individual may then apply section 1034 by filing an amended income tax return for the year of the sale of the principal residence and claim a refund. A nonresident alien may not claim the benefits of section 1034 unless such individual files a complete and timely income tax return with the appropriate forms for the year of the sale of the principal residence. The rules of this paragraph (a)(5)(ii) shall first apply to the sale of principal residences after June 6, 1988. A nonresident alien individual who sells his principal residence that is a U.S. real property interest on or before June 6, 1988, shall, to the extent provided by section 1034, not recognize gain on the sale of the principal residence if the new principal residence is a U.S. real property interest.

(6) *Determination of basis*. If a nonrecognition provision applies to the transfer of a U.S. real property interest pursuant to the provisions of this section, then the basis of the property received in the exchange shall be determined in accordance with the rules generally applicable with respect to such nonrecognition provision. Similarly, the basis of the exchanged property in the hands of the transferee shall be determined in accordance with the rules that generally apply to such transfer.

(7) *Examples*. The rules of paragraph (a)(1) through (6) of this section may be illustrated by the following examples. In each instance, the filing requirements of paragraph (d)(1)(iii) of §1.897-5T have been satisfied.

Example (1). (i) A is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. A owns Parcel P, a U.S. real property interest, with a fair market value of $500,000 and an adjusted basis of $300,000. A transfers Parcel P to DC, a newly formed U.S. real property holding corporation wholly owned by A, in exchange for DC stock.

(ii) Under paragraph (a)(1) of this section, A has exchanged a U.S. real property interest (Parcel P) for another U.S. real property interest (DC stock) which is subject to U.S. taxation upon its disposition. The nonrecognition provisions of section 351(a) apply to A's transfer of Parcel P.

(iii) Under paragraph (a)(6) of this section, the basis of the DC stock received by A is determined in accordance with the rules generally applicable to the transfer. A takes a $300,000 adjusted basis in the DC stock under the rules of section 358(a)(1).

Example (2). (i) A is a citizen and resident of Country F who is stationed in Washington, DC as a full-time employee of an international organization. A sells his principal residence in Washington, and in the same taxable year A purchases another principal residence in Washington. The cost of the new residence exceeds the adjusted sales price of the old residence.

(ii) Under section 7701(b), A is a nonresident alien for U.S. tax purposes, and is subject to taxation under section 897(a). Under paragraphs (a)(1) and (5)(ii) of this section, A is considered to have exchanged a U.S. real property interest (the old principal residence) for another U.S.real property interest (the new principal residence) which is subject to U.S. taxation upon its disposition. The nonrecognition and basis provisions of section 1034(a) apply to A.

Example (3). If in *Example* (2) A had instead purchased a new principal residence in Country F, there would be an exchange of a U.S. real property interest for property that is not a U.S. real property interest. Under paragraph (a)(5)(i) of this section, A would recognize gain under section 897(a) on the disposition of the old principal residence.

Example (4). (i) B is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. B owns stock in DC1, a U.S. real property holding corporation. In a reorganization qualifying for nonrecognition under section 368(a)(1)(B), B exchanges the DC1 stock under section 354(a) for stock in DC2, a U.S. real property holding corporation.

(ii) A does not recognize any gain under paragraph (a)(1) of this section on the exchange of the DC1 stock for DC2 stock because there is an exchange of a U.S. real property interest (the DC1 stock) for another U.S. real property interest (the DC2 stock) which is subject to U.S. taxation upon its disposition.

Example (5). (i) C is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. C owns all of the stock of DC, a U.S. real property holding corporation. The fair market value of the DC stock is 500x, and C has a basis of 100x in the DC stock.

(ii) In a transaction qualifying as a distribution of stock of a controlled corporation under section 355(a), DC distributes to C all of the stock of FC, a foreign corporation that has not made a section 897(i) election. C does not surrender any of the DC stock. The FC stock has a fair market value of 200x. After the distribution, the DC stock has a fair market value of 300x.

(iii) Under the rules of paragraph (a)(4) of this section, C is considered to have exchanged DC stock with a fair market value of 200x and an adjusted basis of 40x for FC stock with a fair market value of 200x. Because the FC stock is not a U.S. real property interest, C must recognize gain of 160x under section 897(a) on the distribution. C takes a basis of 200x in the FC stock. C's basis in the DC stock is reduced to 60x pursuant to section 358(a).

Example (6). (i) A is an individual citizen and resident of Country F. F has an income tax treaty with the United States that exempts gain from the sale of stock, but not real property, by a resident of F from U.S. taxation. In 1981, A transferred Parcel P, an appreciated U.S. real property interest, to DC, a U.S. real property holding corporation, in exchange for DC stock. A owned all of the stock of DC.

(ii) Under the rules of paragraph (a)(1) of this section, A must recognize gain on the transfer of Parcel P. Even though there is an exchange of a U.S. real property interest for another U.S. real property interest, there is gain recognition because the U.S. real property interest received (the DC stock) would not have been subject to U.S. taxation upon a disposition immediately following the exchange. A may not convert a U.S. real property interest that was subject to taxation under section 897 into a U.S. real property interest that could be sold without taxation under section 897 due to a treaty exemption.

Example (7). (i) A, a nonresident alien, organized FC1, a Country W corporation in September 1980 to invest in U.S. real property. FC1's only asset is Parcel P, a U.S. real property interest with a fair market value of $500,000 and an adjusted basis of $200,000. The FC1 stock has a fair market value of $500,000 and A's basis in the FC1 stock is $100,000. The United States does not have a treaty with Country W.

(ii) A, organized FC2, a Country W corporation in July 1987. FC2 organized DC in August 1987. Pursuant to a plan of reorganization under section 368(a)(1)(C), FC1 transfers Parcel P to DC in exchange for FC2 voting stock. As a result of the transfer, DC is a U.S. real property holding corporation wholly owned by FC2. The FC2 stock used by DC in the acquisition had been transferred by FC2 to DC as part of the plan of reorganization. FC1 distributes the FC2 stock to A in exchange for A's FC1 stock.

(iii) FC1's exchange of Parcel P for the FC2 stock under section 361(a) is a disposition of a U.S. real property interest. FC1 must recognize gain of $300,000 under section 897(e) and paragraph (a)(1) of this section on the exchange because the FC2 stock received in exchange for Parcel P is not a U.S. real property interest.

(iv) Under section 362(b), DC takes a basis of $500,000 in Parcel P. FC2 takes a basis of $500,000 in the DC stock. A takes a basis of $100,000 in the FC2 stock under section 358(a)(1). Section 897(d) and paragraph (c)(1) of §1.897-5T do not apply to FC1's distribution of the FC2 stock because the FC2 stock is not a U.S. real property interest.

Example (8). The facts are the same as in *Example (7)*, except that the United States has a treaty with Country W that entitles FC1 and FC2 to nondiscriminatory treatment as described in §1.897-3(b)(2). FC1, but not FC2, makes a valid section 897(i) election prior to the transaction.

(ii) FC1's transfer of Parcel P to DC in exchange for FC2 stock is not subject to section 897(e) and paragraph (a)(1) of this section because FC1 made an election under section 897(i). DC takes a basis of $200,000 in Parcel P under section 362(b).

(iii) FC1's distribution of the FC2 stock to A in exchange for the FC1 stock is not subject to the section 897(d) and paragraph (c)(1) of §1.897-5T because FC1 made an election under section 897(i).

(iv) A must recognize gain on the exchange under section 354(a) of the FC1 stock for the FC2 stock. A exchanged a U.S. real property interest (the FC1 stock) for an interest which is not a U.S. real property interest (the FC2 stock). A recognizes gain of $400,000. Under section 1012, A takes a $500,000 basis in the FC2 stock.

Example (9). (i) The facts are the same as in *Example (7)* except that the United States has a treaty with Country W that entitles FC1 and FC2 to nondiscriminatory treatment as described in §1.897-3(b)__(2). FC2, but not FC1, makes a valid section 897(i) election prior to the transaction.

(ii) FC1's exchange of Parcel P for the FC2 stock under section 361(a) is a disposition of a U.S. real property interest. FC1 does not recognize any gain under section 897(e) and paragraph (a)(1) of this section because there is an exchange of a U.S. real property interest (Parcel P) for another U.S. real property interest (the FC2 stock). DC takes a basis of $200,000 in Parcel P under section 362(b). FC2 takes a basis of $200,000 in the DC stock.

(iii) FC1's distribution of the FC2 stock to A in exchange for the FC1 stock is subject to section 897(d) and paragraph (c)(1) of §1.897-5T. Because A takes a basis of $100,000 in the FC2 stock under section 358(a) (which is less than the $200,000 basis of the FC2 stock in the hands of FC1), and A would be subject to U.S. taxation under section 897(a) on a subsequent disposition of the FC2 stock, FC1 does not recognize any gain under paragraph (c)(1) of §1.897-5T due to the statutory exception of paragraph (c)(2)(i) of that section, provided that FC1 complies with the filing requirements of paragraph (d)(1)(C) of §1.897-5T.

(iv) Since the FC1 stock was not a U.S. real property interest, its disposition by A in the section 354(a) exchange for FC2 stock is not subject to section 897(e) and paragraph (a)(1) of this section.

Example (10). The facts are the same as in *Example (7)*, except that the United States has a treaty with Country W that entitles FC1 and FC2 to nondiscriminatory treatment as described in §1.897-3(b)(2). FC1 and FC2 made valid section 897(i) elections prior to the transactions.

(ii) FC1's transfer of Parcel P to DC in exchange for FC1 stock is not subject to section 897(e) and paragraph (a)(1) of this section because FC1 made an election under section 897(i). DC takes a basis of $200,000 in Parcel P under section 362(a). FC2 takes a basis of $200,000 in the DC stock.

(iii) FC1's distribution of the FC2 stock to A in exchange for the FC1 stock is not subject to section 897(d) and paragraph (c)(1) of §1.897-5T because FC1 made an election under section 897(i).

(iv) A does not recognize any gain on the exchange of the FC1 stock for the FC2 stock under section 354(a). Under paragraph (a)(1) of this section, there is an exchange of a U.S. real property interest (FC1 stock) for another U.S. real property interest (FC2 stock). A takes a basis of $100,000 in the FC2 stock under section 358(a).

(8) *Treatment of nonqualifying property*—(i) *In general.* If, under paragraph (a)(1) of this section, a nonrecognition provision would apply to an exchange but for the fact that nonqualifying property (cash or property other than U.S. real property interests) is received in addition to property (U.S. real property interests) that is permitted to be received under paragraph (a)(1) of this section, then the transferor shall recognize gain under this section equal to the lesser of—

(A) The sum of the cash received plus the fair market value of the nonqualifying property received, or

(B) The gain realized with respect to the U.S. real property interest transferred.

However, no loss shall be recognized pursuant to this paragraph (a)(8) unless such loss is otherwise permitted to be recognized.

(ii) *Treatment of mixed exchanges.* In a mixed exchange where both a U.S. real property interest and other property (including cash) is transferred in exchange both for property the receipt of which would qualify for nonrecognition treatment pursuant to paragraph (a)(1) of this section and for other property (including cash) which would not so qualify, the transferor will recognize gain in accordance with the rules set forth in subdivisions (A) through (C) of this paragraph (a)(8)(ii).

(A) *Allocation of nonqualifying property.* The amount of nonqualifying property (including cash) considered to be received in exchange for U.S. real property interests shall be determined by multiplying the fair market value of the nonqualifying property received by a fraction ("real property fraction"). The numerator of the fraction is the fair market value of the U.S. real property interest transferred in the exchange. The denominator of the fraction is the fair market value of all property transferred in the exchange.

(B) *Recognition of gain.* The amount of gain that must be recognized, and that shall be subject to U.S. taxation by reason of the operation of section 897, shall be equal to the lesser of:

(*1*) The amount determined under subdivision (A) of this paragraph (a)(8)(ii), or

(*2*) The gain or loss realized with respect to the U.S. real property interest exchanged.

(C) *Treatment of other amounts.* The treatment of other amounts received in a mixed exchange shall be determined as follows:

(*1*) The amount of nonqualifying property (including cash) considered to be received in exchange for property (including cash) other than U.S. real property interests shall be treated in the manner provided in the relevant nonrecognition provision. Such amounts shall be determined by subtracting the amount determined under subdivision (A) of this paragraph (a)(8)(ii) from the total amount of nonqualifying property received in the exchange.

(*2*) The amount of qualifying property considered to be received in exchange for U.S. real property interests shall be treated in the manner provided in paragraph (a)(1) of this section. Such amount shall be determined by multiplying the total fair market value of qualifying property received in the exchange by the real property fraction described in subdivision (A) of this paragraph (a)(8)(ii).

(*3*) The amount of qualifying property considered to be received in exchange for property other than U.S. real property interests shall be treated in the manner provided in the relevant nonrecognition provision. Such amount shall be determined by subtracting the amount determined under subdivision (*2*) of this paragraph (a)(8)(ii)(C) from the total fair market value of qualifying property received in the exchange.

(iii) *Example.* The rules of paragraph (a)(8)(ii) of this section may be illustrated by the following example.

Example. (i) A is an individual citizen and resident of country F. Country F does not have an income tax treaty with the United States. A is the sole proprietor of a business located in the United States, the assets of which consist of a U.S. real property interest with a fair market value of $1,000,000 and an adjusted basis of $700,000 and equipment used in the business with a fair market value of $500,000 and an adjusted basis of $250,000. A decides to incorporate the business, and on January 1, 1987, A transfers his assets to domestic corporation DC in exchange for 100 percent of the stock of DC, with a fair market value of $900,000. In addition, A receives a long term note (constituting a security) from DC for $600,000, bearing arm's length interest and repayment terms. DC has no assets other than those received in the exchange with A. Pursuant to section 897(c)(2) and §1.897-2, DC is a U.S. real property holding corporation. Therefore, the stock of DC is a U.S. real property interest. Assume that the note from DC constitutes an interest in the corporation solely as a creditor as provided by §1.897-1(d)(4) of the regulation. A complies with the filing requirements of paragraph (d)(1)(iii) of §1.897-5T.

(ii) Because the note from DC would not be subject to U.S. taxation upon its disposition, it is nonqualifying property for purposes of determining whether A is entitled to receive nonrecognition treatment pursuant to section 351 with respect to his exchange of the U.S. real property interest. Thus, A must recognize gain in the manner provided in paragraph (a)(8)(ii) of this section. Pursuant to paragraph (a)(8)(ii)(A), the amount of nonqualifying property received in exchange for the real property interests is determined by multiplying the fair market value of such property ($600,000) by the real property fraction. The numerator of the fraction is $1,000,000, the fair market value of the real property transferred by A. The denominator is $1,500,000, the fair market value of all property transferred by A. Thus, A is considered to have received $400,000 of the note in exchange for the real property ($600,000 × $1,000,000/$1,500,000). Pursuant to paragraph (a)(8)(ii)(B), A must recognize the lesser of the amount initially determined or the gain realized with respect to the U.S real property interest. Therefore, A must recognize the $300,000 gain realized with respect to the real property.

(iii) Pursuant to paragraph (a)(8)(ii)(C) of this section, A is considered to have received $200,000 of the note in exchange for equipment $600,000 [total value of note received] minus $400,000 [portion of note received in exchange for real property]), $600,000 of the stock in exchange for real property ($900,000 [total value of stock received] times $1,000,000/1,500,000 [proportion of property exchanged consisting of real property]), and $300,000 of the stock in exchange for equipment ($900,000 [total value of stock received] minus $600,000 [portion of stock received in exchange for real property). All three amounts are entitled to nonrecognition treatment pursuant to section 351.

(iv) Pursuant to paragraph (a)(2) of this section, A's basis in the stock and note received and DC's basis in the U.S. real property interest and equipment will be determined in accordance with the generally applicable rules. The $400,000 portion of the note received in exchange for the real property interest is other property. Pursuant to section 358(a)(2), A takes a fair market value ($400,000) basis for that portion of the note. Pursuant to section 358(a)(1), A's basis in the property received without the recognition of gain (the DC stock and the other portion of the note) will be equal to the basis of the property transferred ($950,000 [$700,000 basis of U.S. real property interest plus $250,000 basis of equipment]), decreased by the fair market value of the other property received ($400,000 portion of the note), and increased by the amount of gain recognized to A on the transaction ($300,000). Thus, A's basis in the stock and the nonrecognition portion of the note is $850,000 ($950,000 − $400,000 + $300,000). Under §1.358-2(b)(2) of the regulations, the $850,000 is allocated between the stock and the nonrecognition portion of the note in proportion to their fair market values. A takes a basis of $697,000 in the DC stock ($850,000 × 900,000/1,100,000). A takes a basis of $153,000 in the nonrecognition portion of the note ($850,000 × 200,000/1,100,000). A's basis in the note is $553,000 ($400,000 + $153,000). DC's basis in the property received from A will be determined under section 362(a). DC takes a basis of $1,000,000 in the real property interest (A's basis of $700,000 increased by the $300,000 of gain recognized by A on it). DC takes a basis of $250,000 in the equipment (A's basis of $250,000).

(9) *Treaty exception to imposition of tax.* If gain that would be currently recognized pursuant to the provisions of this section is subject to an exemption from, or reduction of, U.S. tax pursuant to a U.S. income tax treaty, then gain shall be recognized only as provided by that treaty for dispositions occurring before January 1, 1985. For dispositions occurring after December 31, 1984, all gain shall be recognized as provided in section 897 and the regulations thereunder, except as provided by Articles XII(9) and XXX(5) of the United States-Canada Income Tax Convention or other income tax treaty entered into after June 6, 1988. In regard to Article XXX(5) the Income Tax Treaty with Canada, see, Rev. Rul. 85-76, 1985-1 C.B. 409.

(b) *Certain foreign to foreign exchanges*—(1) *Exceptions to the general rule.* Notwithstanding the provisions of paragraph (a)(1) of this section and pursuant to authority conferred by section 897(e)(2), a foreign person shall not recognize gain, in the instances described in paragraph (b)(2) of this section, on the transfer of a U.S. real property interest to a foreign corporation in exchange for stock in a foreign corporation, but only if the transferee's subsequent disposition of the transferred U.S real property interest would be subject to U.S. taxation, as determined in accordance with the provisions of §1.897-5T (d)(1), if the filing requirements of paragraph (d)(1)(iii) of §1.897-5T have been satisfied, if one of the five conditions set forth in paragraph (b)(2) exists, and if one of the following three forms of exchange takes place.

(i) The exchange is made by a foreign corporation pursuant to section 361(a) in a reorganization described in section 368(a)(1)(D) or (F) and there is an exchange of the transferor corporation stock for the transferee corporation stock under section 354(a); or

(ii) The exchange is made by a foreign corporation pursuant to section 361(a) in a reorganization described in section 368(a)(1)(C); there is an exchange of the transferor corporation stock for the transferee corporation stock (or stock of the transferee corporation's parent in the case of a parenthetical C reorganization) under section 354(a); and the transferor corporation's shareholders own more than fifty percent of the voting stock of the transferee corporation (or stock of the transferee corporation's parent in the case of a parenthetical C reorganization) immediately after the reorganization; or

(iii) The U.S. real property interest exchanged is stock in a U.S. real property holding corporation; the exchange qualifies under section 351(a) or section 354(a) in a reorganization described in section 368(a)(1)(B); and immediately after the exchange, all of the outstanding stock of the transferee corporation (or stock of the transferee corporation's parent in the case of a parenthetical B reorganization) is owned in the same proportions by the same nonresident alien individuals and foreign corporations that, immediately before the exchange, owned the stock of the U.S. real property holding corporation.

If, however, a nonresident alien individual or foreign corporation which received stock in an exchange described in subdivision (iii) of this paragraph (b)(1) (or the transferee corporation's parent) disposes of any of such foreign stock within three years from the date of its receipt, then that individual or corporation shall recognize that portion of the gain realized with respect to the stock in the U.S. real property holding corporation for which foreign stock disposed of was received.

(2) *Applicability of exception.* The exception to the provisions of paragraph (a)(1) provided by paragraph (b)(1) shall apply only if one of the following five conditions exists.

(i) Each of the interests exchanged or received in a transferor corporation or transferee corporation would not be a U.S. real property interest as defined in §1.897-1(c)(1) if such corporations were domestic corporations; or

(ii) The transferee corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) is incorporated in a foreign country that maintains an income tax treaty with the United States that contains an information exchange provision; the transfer occurs after May 5, 1988; and the transferee corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) submit a binding waiver of all benefits of the respective income tax treaty (including the opportunity to make an election under section 897(i)), which must be attached to each of the transferor and transferee corporation's income tax returns for the year of the transfer; or

(iii) The transferee foreign corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) is a qualified resident as defined in section 884(e) and any regulations thereunder of the foreign country in which it is incorporated; or

(iv) The transferee foreign corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) is incorporated in the same foreign country as the transferor foreign corporation; and there is an income tax treaty in force between that foreign country and the United States at the time of the transfer that contains an exchange of information provision; or

(v) The transferee foreign corporation is incorporated in the same foreign country as the transferor foreign corporation; and the transfer is incident to a mere change in identity, form, or place of organization of one corporation under section 368(a)(1)(F).

For purposes of any election by a transferee foreign corporation (or the transferee corporation's parent in the case of a parenthetical C reorganization) to be treated as domestic corporation under section 897(i) and §1.897-3 where the exchange was described in subdivisions (i) or (ii) of paragraph (b)(1) of this section, any prior dispositions of the transferor foreign corporation stock will be subject to the requirements of §1.897-3(d)(2) upon an election under section 897(i) by the transferee foreign corporation (or the transferee foreign corporation (or the transferee corporation's parent in the case of a parenthetical C reorganization).

(3) *No exceptions.* No exception to recognition of gain under paragraph (a)(1) of this section is provided for the transfer of a U.S. real property interest by a foreign person to a foreign corporation in exchange for stock in a foreign corporation other than as provided in this paragraph (b). Thus, no exception is provided where—

(i) Such exchange is made pursuant to section 351 and the U.S. real property interest transferred is not stock in a U.S. real property holding corporation; or

(ii) Such exchange is made pursuant to section 361(a) in a reorganization described in section 368(a)(1) that does not qualify for nonrecognition of gain under this paragraph (b). With regard to the treatment of certain foreign corporations as domestic corporations under section 897(i), see §§1.897-3 and 1.897-8T.

(4) *Examples.* The rules of paragraph (b)(1) and (2) of this section may be illustrated by the following examples. In each instance, the filing requirements of paragraph (d)(1)(iii) of §1.897-5T have been satisfied.

Example (1). (i) FC is a Country F corporation that has not made a section 897(i) election. FC owns Parcel P, a U.S. real property interest, with a fair market value of $450x and an adjusted basis of 100x.

(ii) FC transfers Parcel P to FS, its wholly owned Country F subsidiary, in exchange for FS stock under section 351(a). FS has not made a section 897(i) election. Under the rules of paragraph (a)(1) of this section, FC must recognize gain of 350x under section 897(a) because the FS stock received in the exchange is not a U.S. real property interest. No exception to the recognition rule of paragraph (a)(1) is provided under this paragraph (b) for a transfer under section 351(a) of a U.S. real property interest (that is not stock in a U.S. real property holding corporation) by a foreign corporation to another foreign corporation in exchange for stock of the transferee corporation.

Example (2). (i) FC is a Country F corporation that has not made a section 897(i) election. FC owns several U.S. real property interests that have appreciated in value since FC purchased the interests. FP, a Country F corporation, owns all of the outstanding stock of FC. Country F maintains an income tax treaty with the United States.

(ii) For valid business purposes, FC transferred substantially all of its assets including all of its U.S. real property interests to FS in 1989 under section 361(a) in a reorganization in exchange for FS stock. FS is a newly formed Country F corporation that is owned by FC. The transfer qualifies as a reorganization under section 368(a)(1)(D). FC immediately distributes the FS stock to FP in exchange for the FC stock and FC dissolves. FP has no gain or loss on the exchange of the FC stock for the FS stock under section 354(a).

(iii) Under the rules of paragraph (b)(1)(i) of this section, FC does not recognize any gain on the transfer of the U.S. real property interests to FS under section 361(a) in the reorganization under section 368(a)(1)(D) because FS would be subject to U.S. taxation on a subsequent disposition of the interests, as required by paragraph (b)(1) of this section; there is an exchange of stock under section 354(a), as required by paragraph (b)(1)(i); and FC and FS are incorporated in Country F which maintains an income tax treaty with the United States, as required by paragraph (b)(2)(iv).

(5) *Contributions of property.* A foreign person that contributes a U.S. real property interest to a foreign corporation as paid in surplus or as a contribution to capital (including a contribution provided in section 304(a)) shall be treated, for purposes of section 897(j) and this section, as exchanging the U.S. real property interest for stock in the foreign corporation.

(c) *Denial of nonrecognition with respect to certain tax avoidance transfers*—(1) *In general.* The provisions of §1.897-5T and paragraphs (a) and (b) of this section are subject to the rules of this paragraph (c).

(2) *Certain transfers to domestic corporations*—(i) *General rule.* If a foreign person transfers property, that is not a U.S. real property interest, to a domestic corporation in a nonrecognition exchange, where—

(A) The adjusted basis of such property transferred exceeded its fair market value on the date of the transfer to the domestic corporation;

(B) The property transferred will not immediately be used in, or held by the domestic corporation for use in, the conduct of a trade or business as defined in §1.897-1(f); and

(C) Within two years of the transfer to the domestic corporation, the property transferred is sold at a loss;

then, it will be presumed, absent clear and convincing evidence to the contrary, that the purpose for transferring the loss property was the avoidance of taxation on the disposition of U.S. real property interests by the domestic corporation. Any loss recognized by the domestic corporation on the sale or exchange of such property shall not be used by the domestic corporation, either by direct offset or as part of a net operating loss or capital loss carryback or carryover to offset any gain recognized from the sale or exchange of a U.S. real property interest by the domestic corporation.

(ii) *Example.* The rules of paragraph (c)(2)(i) of this section may be illustrated by the following example.

Example. A is an individual citizen and resident of country F, which does not have an income tax treaty with the U.S. On January 1, 1987, A transfers a U.S. real property interest with a basis of $100,000 and a fair market value of $600,000 to domestic corporation DC in exchange for all of the stock of DC. On October 20, 1987, A transfers stock of a publicly traded domestic corporation with a basis in his hands of $900,000 and a fair market value of $500,000, in exchange for additional stock of DC. The stock of the publicly traded domestic corporation does not constitute an asset used or held for use in DC's trade or business. If DC sells the stock of the publicly traded domestic corporation before October 20, 1989 and recognizes a loss, the loss may not be used to offset any gain recognized on the sale of the U.S. real property interests by DC.

(3) *Basis adjustment for certain related person transactions.* In the case of any disposition after December 31, 1979, of a U.S. real property interest to a related person (within the meaning of section 453(f)(1)), the basis of the interest in the hands of the person acquiring such interest shall be reduced by the amount of any gain which is not subject to taxation under section 871(b)(1) or 882(a)(1) because the disposition occurred before June 19, 1980 or because of any treaty obligation of the United States. If a foreign corporation makes an election under section 897(i), and the stock of such corporation was transferred between related persons after December 31, 1979 and before June 19, 1980, then such stock shall be treated as a U.S. real property interest solely for purposes of this paragraph (c)(3).

(4) *Rearrangement of ownership to gain treaty benefit.* A foreign person who directly or indirectly owns a U.S. real property interest may not directly or indirectly rearrange the incidents of ownership of the U.S. real property interest through the use of nonrecognition provisions in order to gain the benefit of a treaty exemption from taxation. Such nonrecognition will not apply to the foreign transferor. The transferor will recognize gain but not loss on the transfer under section 897(a).

(d) *Effective date.* Except as specifically provided otherwise in the text of the regulations, paragraphs (a) through (c) shall be effective for transfers, exchanges and other dispositions occurring after June 18, 1980. Paragraph (a)(5)(ii) of this section shall be effective for exchanges and elections occurring after June 6, 1988.

§1.897-7T Treatment of certain partnership interests as entirely U.S. real property interests under sections 897(g) and 1445(e) (Temporary).

(a) *Rule.* Pursuant to section 897(g), an interest in a partnership in which, directly or indirectly, fifty percent or more of the value of the gross assets consist of U.S. real property interests, and ninety percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents shall, for purposes of section 1445, be treated as entirely a U.S. real property interest. For purposes of section 897(g), such interest shall be treated as a

U.S. real property interest only to the extent that the gain on the disposition is attributable to U.S. real property interests (and not cash, cash equivalents or other property). Consequently, a disposition of any portion of such partnership interest shall be subject to partial taxation under section 897(a) and full withholding under section 1445(a). For purposes of this paragraph, cash equivalent means any asset readily convertible into cash (whether or not denominated in U.S. dollars) including, but not limited to, bank accounts, certificates of deposit, money market accounts, commercial paper, U.S. and foreign treasury obligations and bonds, corporate obligations and bonds, precious metals or commodities, and publicly traded instruments.

(b) *Effective date.* Section 1.897-7T shall be effective for transfers, exchanges, distributions and other dispositions occurring after June 6, 1988.

§1.897-8T Status as a U.S. real property holding corporation as a condition for electing section 897(i) pursuant to §1.897-3 (Temporary).

(a) *Purpose and scope.* This section provides a temporary regulation that, if and when adopted as a final regulation, will be added to paragraph (b) of §1.897-3. Paragraph (b) of this section would then appear as paragraph (b)(4) of §1.897-3.

(b) *General conditions.* The foreign corporation upon making an election under section 897(i) (including any retroactive election) must qualify as a U.S. real property holding corporation as defined in paragraph (b)(1) of §1.897-2.

(c) *Effective date.* Section 1.897-8T shall be effective as of June 6, 1988, with respect to foreign corporations making an election under section 897(i) after May 5, 1988.

§1.897-9T Treatment of certain interest in publicly traded corporations, definition of foreign person, and foreign governments and international organizations. (Temporary).

(a) *Purpose and scope.* This section provides a temporary regulation that, if and when adopted as a final regulation, will be added as new paragraphs (c)(2)(iii)(B),(k), (n) and (q) of §1.897-1. Paragraph (b) of this section would then appear as paragraph (c)(2)(iii)(B) of §1.897-1. Paragraph (c) of this section would then appear as paragraph (k) of §1.897-1. Paragraph (d) of this section would then appear as paragraph (n) of §1.897-1. Paragraph (e) of this section would then appear as paragraph (q) of §1.897-1.

(b) Any other interest in the corporation (other than an interest solely as a creditor) if on the date such interest was acquired by its present holder it had a fair market value greater than the fair market value on that date of 5 percent of the regularly traded class of the corporation's stock with the lowest fair market value. However, if a non-regularly traded class of interests in the corporation is convertible into a regularly traded class of interests in the corporation, an interest in such non-regularly traded class shall be treated as a U.S. real property interest if on the date it was acquired by its present holder it had a fair market value greater than the fair market value on that date of 5 percent of the regularly traded class of the corporation's stock into which it is convertible. If a person holds interests in a corporation of a class that is not regularly traded, and subsequently acquires additional interests of the same class, then all such interests must be aggregated and valued as of the date of the subsequent acquisition. If the subsequent acquisition causes that person's interests to exceed the applicable limitation, then all such interests shall be treated as U.S. real property interests, regardless of when acquired. In addition, if a person holds interests in a corporation of separate classes that are not regularly traded, and if such interests were separately acquired for a principal purpose of avoiding the applicable 5 percent limitation of this paragraph, then such interests shall be aggregated for purposes of applying that limitation. This rule shall not apply to interests of separate classes acquired in transactions more than three years apart. For purposes of paragraph (c)(2)(iii) of §1.897-1, section 318(a) shall apply (except that section 318(a)(2)(C) and (3)(C) shall each be applied by substituting "5 percent" for "50 percent").

(c) *Foreign person.* The term "foreign person" means a nonresident alien individual (including an individual subject to the provisions of section 877), a foreign corporation as defined in paragraph (l) of this section, a foreign partnership, a foreign trust or a foreign estate, as such persons are defined respectively by §1.871-2 and by 7701 and the regulations thereunder. A resident alien individual, including a nonresident alien with respect to whom there is in effect an election under section 6013(g) or (h) to be treated as United States resident, is not a foreign person. With respect to the status of foreign governments and international organizations, see paragraph (e) of this section.

(d) *Regularly traded—*(1) *General rule—*(i) *Trading requirements.* A class of interests that is traded on one or more established securities markets is considered to be regularly traded on such market or markets for any calendar quarter during which—

(A) Trades in such class are effected, other than in *de minimis* quantities, on at least 15 days during the calendar quarter;

(B) The aggregate number of the interests in such class traded is at least 7.5 percent or more of the average number of interests in such class outstanding during the calendar quarter; and

(C) The requirements of paragraph (d)(3) of this section are met.

(ii) *Exceptions.*—(A) In the case of the class of interests which is held by 2,500 or more record shareholders, the requirements of paragraph (d)(1)(i)(B) of this section shall be applied by substituting "2.5 percent" for "7.5 percent".

(B) If at any time during the calendar quarter 100 or fewer persons own 50 percent or more of the outstanding shares of a class of interests, such class shall not be considered to be regularly traded for purposes of sections 897, 1445 and 6039C. Related persons shall be treated as one person for purposes of this paragraph (d)(1)(ii)(B).

(iii) *Anti-abuse rule.* Trades between related persons shall be disregarded. In addition, a class of interests shall not be treated as regularly traded if there is an arrangement or a pattern of trades designed to meet the requirements of this paragraph (d)(1). For example, trades between two persons that occur several times during the calendar quarter may be treated as an arrangement or a pattern of trades designed to meet the requirements of this paragraph (d)(1)

(2) *Interests traded on domestic established securities markets.* For purposes of sections 897, 1445 and 6039C, a class of interests that is traded on an established securities market located in the United States is considered to be regularly traded for any calendar quarter during which it is regularly quoted by brokers or dealers making a market in such interests. A broker or dealer makes a market in a class of interests only if the broker or dealer holds himself out to buy or sell interests in such class at the quoted price. Stock of a corporation that is described in section 851(a)(1) and units of a unit investment trust registered under the Investment Company Act of 1940 (15 U.S.C. sections 80a-1 to 80a-2) shall be treated as regularly traded within the meaning of this paragraph.

(3) *Reporting requirement for interests traded on foreign securities markets.* A class of interests in a domestic corporation that is traded on one or more established securities markets located outside the United States shall not be considered to be regularly traded on such market or markets unless such class is traded in registered form, and—

(i) The corporation registers such class of interests pursuant to section 12 of the Securities Exchange Act of 1934, 15 U.S.C., sec. 78, or

(ii) The corporation attaches to its federal income tax return a statement providing the following:

(A) A caption which states "The following information concerning certain shareholders of this corporation is provided in accordance with the requirements of §1.897-9T."

(B) The name under which the corporation is incorporated, the state in which such corporation is incorporated, the principal place of business of the corporation, and its employer identification number, if any;

(C) The identity of each person who, at any time during the corporation's taxable year, was the beneficial owner of more than 5 percent of any class of interests of the corporation to which this paragraph (d)(3) applies;

(D) The title, and the total number of shares issued, of any class of interests so owned; and

(E) With respect to each beneficial owner of more than 5 percent of any class of interests of the corporation, the number of shares owned, the percentage of the class represented thereby, and the nature of the beneficial ownership of each class of shares so owned.

Interests in a domestic corporation which has filed a report pursuant to this paragraph (d)(3)(ii) shall be considered to be regularly traded on an established securities market only for the taxable year of the corporation with respect to which such a report is filed.

(4) *Coordination with section 1445.* For purposes of section 1445, a class of interests in a corporation shall be presumed to be regularly traded during a calendar quarter if such interests were regularly traded within the meaning of this paragraph during the previous calendar quarter.

(e) *Foreign governments and international organizations.* A foreign government shall be treated as a foreign person with respect to U.S. real property interests, and shall be subject to sections 897, 1445, and 6039C on the disposition of a U.S. real property interest except to the extent specifically otherwise provided in the regulations issued under section 892. An international organization (as defined in section 7701(a)(18)) is not a foreign person with respect to U.S. real property interests, and is not subject to sections 897, 1445, and 6039C on the disposition of a U.S. real property interest. Buildings or parts of buildings and the land ancillary thereto (including the residence of the head of the diplomatic mission) used by the foreign government for a diplomatic mission shall not be a U.S. real property interest in the hands of the respective foreign government.

(f) *Effective date.* Section 1.897-9T with the exception of paragraph (e) shall be effective for transfers, exchanges, distributions and other dispositions occurring on or after June 6, 1988. Paragraph (e) of this section shall be effective for transfers, exchanges, distributions and other dispositions occurring on or after July 1, 1986.

Par. 4. Section 1.1445-2 is amended by removing paragraph (d)(2)(iii), effective after August 3, 1988, and by removing paragraph (d)(2)(iv), effective after June 6, 1988. Section 1.1445-2 is also amended by removing paragraph (d)(6), effective after June 6, 1988. Paragraph (d)(6) is hereby reserved.

Par. 5. Section 1.1445-5 is amended by removing paragraphs (b)(2)(iii), (b)(8)(v), and (c)(2)(i), effective after June 6, 1988. Paragraphs (b)(8)(v) and (c)(2)(i) are hereby reserved.

Par. 6. The following new sections are added immediately after §1.1445-8T.

§1.1445-9T Special rule for section 1034 nonrecognition (Temporary).

(a) *Purpose and scope.* This section provides a temporary regulation that, if and when adopted as a final regulation, will add a new paragraph (d)(2)(iii) to §1.1445-2. Paragraph (b) of this section would then appear as paragraph (d)(2)(iii) of §1.1445-2.

(b) No particular form is required for a transferor's notice to a transferee that the transferor is not required to recognize gain or loss with respect to a transfer. The notice must be verified as true and signed under penalties of perjury by a responsible officer in the case of a corporation, by a general partner in the case of a partnership, and by a trustee or equivalent fiduciary in the case of a trust or estate. The following information must be set forth in paragraphs labeled to correspond with the designation set forth below:

(1) A statement that the document submitted constitutes a notice

of a nonrecognition transfer pursuant to the requirements of §1.1445-2(d)(2);

(2) The name, identifying number (if any), and home address (in the case of an individual) or office address (in the case of an entity) of the transferor submitting the notice;

(3) A statement that the transferor is not required to recognize any gain or loss with respect to the transfer;

(4) A brief description of the transfer;

(5) A brief summary of the law and facts supporting the claim that recognition of gain or loss is not required with respect to the transfer; and

(6) If the transferor claims nonrecognition on the sale or exchange of a principal residence under section 1034(a) and another principal residence in the United States has not been purchased as of the date of sale of the principal residence, either (i) a copy of an executed binding contract for purchase by the transferor of a further principal residence in the United States with a purchase price exceeding the adjusted sales price of the old principal residence or (ii) an affidavit by the transferor signed under penalties of perjury stating that the transferor intends to complete purchase of another principal residence within the United States with a purchase price exceeding the adjusted sales price of the old principal residence by April 15 of the year following the taxable year of the sale of the principal residence, and that the transferor is expected to continue to be employed or stationed in the United States for a period of two years from the sale of the principal residence. If the transferor's adjusted sales price of the old principal residence exceeds the transferor's cost of purchasing another principal residence in the United States, withholding shall be required at the rate of ten percent on the portion of the gross amount realized on the sale or exchange of the principal residence equal to such excess.

(c) *Effective Date.* The rules of this section are effective with respect to sale of a principal residence after August 3, 1988.

§1.1445-10T Special rule for Foreign governments (Temporary).

(a) This section provides a temporary regulation that, if and when adopted as a final regulation, will add a new paragraph (d)(6) to §1.1445-2. Paragraph (b) of this section would then appear as paragraph (d)(6) of §1.1445-2.

(b) *Foreign government*—(1) *As transferor.* A foreign government is subject to U.S. taxation under section 897 on the disposition of a U.S. real property interest except to the extent specifically otherwise provided in the regulations issued under section 892. A foreign government that disposes of a U.S. real property interest that is not subject to taxation as specifically provided by the regulations under section 892 may present a notice of nonrecognition treatment pursuant to paragraph (d)(2) of this section that specifically cites the provision of such regulation, and thereby avoids withholding by the transferee of the property. A foreign government that disposes of a U.S. real property interest or the transferee of the property may obtain a withholding certificate from the Internal Revenue Service that confirms the applicability of section 892, but neither is required to do so. Rules concerning the issuance of withholding certificates are provided in §1.1445-3.

(2) *An transferee.* A foreign government or international organization that acquires a U.S. real property interest is fully subject to section 1445 and the regulations thereunder. Therefore, such an entity is required to withhold tax upon the acquisition of a U.S. real property interest from a foreign person.

(c) *Effective date.* The rules of this section shall be effective for transfers, exchanges, distributions and other dispositions occurring on or after June 6, 1988.

§1.1445-11T Special rules requiring withholding under §1.1445-5 (Temporary).

(a) *Purpose and scope.* This section provides temporary regulations that, if and when adopted as a final regulation, will add certain new paragraphs within §1.1445-5(b) and (c). The paragraphs of this section would then appear as set forth below. Paragraph (b) of this section would then appear as paragraph (b)(8)(v) of §1.1445-5. Paragraph (c) of this section would then appear as paragraph (c)(2)(i) of §1.1445-5. Paragraph (d) of this section would then appear as paragraph (g) of §1.1445-5.

(b) *Disposition of interests in partnerships, trusts, and estates.* The provisions of section 1445(e)(5), requiring withholding upon certain dispositions of interests in partnerships, trusts, and estates, that own directly or indirectly a U.S. real property interest shall apply to dispositions on or after the effective date of a later Treasury decision under section 897(g) of the Code except in the case of dispositions of interests in partnerships in which fifty percent of the value of the gross assets consist of U.S. real property interests and ninety percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents. The provisions of section 1445(e)(5), shall apply, however, to dispositions after June 6, 1988, of interests in partnerships in which fifty percent or more of the value of the gross assets consist of U.S. real property interests, and ninety percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents. See paragraph (d) of this section.

(c) *Transactions covered elsewhere.* No withholding is required under this paragraph (c) with respect to the distribution of a U.S. real property interest by a partnership, trust, or estate. Such distributions shall be subject to withholding under section 1445(e)(4) and paragraph (f) of this §1.1445-5 on the effective date of a later Treasury decision published under section 897(g) of the Code. No withholding is required at this time for distributions described in the preceding sentence. See paragraph (b)(8)(iv) of this §1.1445-5. No withholding is required under this paragraph with respect to the disposition of an interest in a trust, estate, or partnership except in the case of a partnership in which fifty percent or more of the value of the gross assets consist of U.S. real property interests, and ninety percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents. See paragraph (b)(8)(v) of §1.1445-5. Withholding shall be required as provided in section 1445(e)(5) and paragraph (g) of this section with respect to the disposition after June 6, 1988, of an interest in a partnership in which fifty percent or more of the value of the gross assets consist of U.S. real property interests, and ninety percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents.

(d) *Dispositions of interests in partnerships, trusts, and estates*—(1) *Withholding required on disposition of certain partnership interests.* Withholding is required under section 1445(e)(5) and this paragraph with respect to the disposition by a foreign partner of an interest in a domestic or foreign partnership in which fifty percent or more of the value of the gross assets consist of U.S. real property interests, and ninety percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents. For purposes of this paragraph cash equivalents means any asset readily convertible into cash (whether or not denominated in U.S. dollars), including, but not limited to, bank accounts, certificates of deposit, money market accounts, commercial paper, U.S. and foreign treasury obligations and bonds, corporate obligations and bonds, precious metals or commodities, and publicly traded instruments. The taxpayer on filing an income tax return for the year of the disposition may demonstrate the extent to which the gain on the disposition of the interest is not attributable to U.S. real property interests. A taxpayer is also permitted by §1.1445-3 to apply for a withholding certificate in instances where reduced withholding is appropriate.

(2) *Withholding not required*—(i) *Transferee receives statement that interest in partnership is not described in paragraph (1).* No withholding is required under paragraph (d)(1) of this section upon the disposition of a partnership interest otherwise described in that paragraph if the transferee is provided a statement, issued by the partnership and signed by a general partner under penalties of perjury no earlier than 30 days before the transfer, certifying that fifty percent or more of the value of the gross assets does not consist of U.S. real property interests, or that ninety percent or more of the value of the gross assets of the partnership does not consist of U.S. real property interests plus cash or cash equivalents.

(ii) *Reliance on statement not permitted.* A transferee is not entitled to rely upon a statement described in paragraph (d)(2)(i) of this section if, prior to or at the time of the transfer, the transferee either—

(A) Has actual knowledge that the statement is false, or

(B) Receives a notice, pursuant to §1.1445-4.

Such a transferee's withholding obligations shall apply as if the statement had never been given, and such a transferee may be held fully liable pursuant to

§1.1445-1(e) for any failure to withhold.

(iii) *Belated notice of false statement.* If, after the date of the transfer, a transferee receives notice that a statement provided under paragraph (d)(2)(i) of this section is false, then such transferee may rely on the statement only with respect to consideration that was paid prior to the receipt of the notice. Such a transferee is required to withhold a full 10 percent of the amount realized from the consideration that remains to be paid to the transferor. Thus, if 10 percent or more of the amount realized remains to be paid to the transferor, then the transferee is required to withhold and pay over the full 10 percent. The transferee must do so by withholding and paying over the entire amount of each successive payment of consideration to the transferor, until the full 10 percent of the amount realized has been withheld and paid over. Amounts so withheld must be reported and paid over by the 20th day following the date on which each such payment of consideration is made. A transferee that is subject to the rules of this §1.1445-10T(d)(2)(iii) may not obtain a withholding certificate pursuant to §1.1445-3, but must instead withhold and pay over the amounts required by this paragraph.

(e) *Effective date.* The rules of this section are effective for transactions after June 6, 1988.

OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 7. The authority citation for Part 602 continues to read as follows: Authority: 26 USC 7805.

Par. 8. Section 602.101(c) is amended by inserting in the appropriate place in the table "§1.897-5T . . . 1545-0902" "§1.897-6T . . . 1545-0902" "§1.1445-9T . . . 1545-0902" "§1.1445-10T . . . 1545-0902".

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved April 15, 1988.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on May 4, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 5, 1988, 53 F.R. 16214)

Part III.—Income From Sources Without the United States
Subpart A.—Foreign Tax Credit

Section 904.—Limitation on Credit

26 CFR 1.904(f)-13T: Transition rules.

T.D. 8201

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Section 904(f) Transition Rules

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document provides temporary regulations relating to transition rules for implementing the changes made to section 904(f) of the Internal Revenue Code of 1954 by the Tax Reform Act of 1986 [1986-3 (Vol.1) C.B. 1]. The regulations provide the public with the immediate guidance needed to comply with that Act and will affect individuals and entities claiming the foreign tax credit. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in *** [INTL-932-86, page 915, this Bulletin].

DATES; These temporary regulations apply to taxable years beginning after December 31, 1986, and are effective after December 31, 1986.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains Temporary Income Tax Regulations (26 CFR Part 1) under section 904 of the Internal Revenue Code of 1986.

NEED FOR TEMPORARY REGULATIONS

The proper application of section 904(f) is dependent upon the Internal Revenue Service's detailed specifications of the manner in which the requirements of the statue will be administered. Because of the need for immediate guidance in this regard, the Internal Revenue Service has found it to be impractical to issue these temporary regulations either with notice and public comment procedure under section 553(b) of title 5 of the United States Code, or under the effective date limitation of section 553(d) of title 5.

EXPLANATION OF PROVISIONS

Prior Law

Prior to 1987, if a taxpayer sustained a foreign source loss with respect to income in a separate limitation category, the loss was treated as offsetting the taxpayer's U.S. source income before offsetting foreign source income subject to another separate limitation. A foreign tax credit was allowed for the taxpayer's other foreign source income if that income was subject to foreign tax. Thus, it was possible for a taxpayer to enjoy a double benefit in a single taxable year in the form of reduced U.S. source income and a foreign tax credit.

Statutory Provision

Section 1203 of the Tax Reform Act of 1986 amended section 904(f) by adding paragraph (5) at the end thereof which requires that a foreign source loss with respect to any income category first offset the taxpayer's foreign source income subject to other separate limitations for the taxable year on a proportionate basis before the loss offsets the taxpayer's U.S. source income.

Explanation of Temporary Regulations

The Tax Reform Act of 1986 changed the order in which foreign source losses offset U.S. source and foreign source income of a taxpayer and expanded the number of separate limitation categories for income. The Temporary Regulations contained in this document provide transition rules for the treatment of overall foreign losses incurred by a taxpayer in taxable years beginning before January 1, 1987 (pre-effective date years), that are recaptured in taxable years beginning after December 31, 1986 (post-effective date years). In addition, transition rules are provided for an overall foreign loss that is part of a net operating loss incurred in a pre-effective date year which is carried forward to a post-effective date year and for an overall foreign loss that is part of a net operating loss incurred in a post-effective date year which is carried back to a pre-effective date year.

§1.904(f)-13T
Transition rules

Paragraph (a)(1) provides that an overall foreign loss incurred in a pre-effective date year shall be recaptured in post-effective date years by recharacterizing income received in the income category described in section 904(d) as in effect for post-effective date years that is analogous to the income category for which the overall foreign loss account was established. For example, an overall foreign loss incurred with respect to the income category described in section 904(d)(1)(B) (Dividends from a DISC or former DISC) as in effect for pre-effective date years shall be recaptured from income earned in the income category described in section 904(d)(1)(F) (Dividends from a DISC or former DISC) as in effect for post-effective date years.

Paragraph (a)(2)(i) provides, in general, that an overall foreign loss incurred in the general limitation category of section 904(d)(1)(E), as in effect for pre-effective date years, shall be recaptured from the taxpayer's post-effective date general limitation income, financial services income, shipping income and dividends from each noncontrolled section 902 corporation. If the sum of the taxpayer's general limitation income, financial services income, shipping income and dividends from each noncontrolled section 902 corporation for a taxable year subject to recapture exceeds the pre-effective date overall foreign loss to be recaptured, then the amount of each type of separate limitation income that will be treated as U.S. source income is determined pursuant to a formula set forth in paragraph (a)(2)(i).

Paragraph (a)(2)(ii) provides an exception to the general rule for recapture of an overall foreign loss in the general limitation category of section 904(d)(1)(E) as in effect for pre-effective date years if a taxpayer can demonstrate to the satisfaction of the Internal Revenue Service that the loss is attributable, in sums certain, to one or more separate categories of section 904(d)(1), as in effect for post-effective date taxable years. In such a case, the taxpayer may recapture the loss (in the amounts demonstrated) from those limitation categories only.

Paragraph (a)(3) provides that an overall foreign loss incurred by a taxpayer in a pre-effective date year shall be recaptured to the extent thereof before recapture of post-effective date overall foreign losses.

Paragraph (b) provides that an overall foreign loss that is part of a net operating loss incurred in a pre-effective date taxable year which is carried forward to a post-effective date year will be allocated first to income in the income category analogous to the income category set forth in section 904(d) as in effect for pre-effective date taxable years in which the loss occurred. If the loss exceeds income in the analogous income category, the loss shall be allocated to other foreign source income earned by the taxpayer in accordance with the rules set forth in section 904(f)(5). Losses remaining after application of section 904(f)(5) shall be allocated to the taxpayer's U.S. source income, which will create an addition to the taxpayer's overall foreign loss account.

Paragraph (c)(1) provides that an overall foreign loss that is part of a net operating loss incurred by the taxpayer in a post-effective date taxable year which is carried back to a pre-effective date taxable year shall be allocated first to income in the pre-effective date income category analogous to the income category set forth in section 904(d) as in effect for post-effective date taxable years in which the loss occurred. The general limitation income category for pre-effective date years shall be treated as the income category that is analogous to post-effective date general limitation income, financial services income, shipping income, dividends from each noncontrolled section 902 corporation and high withholding tax interest income.

Paragraph (c)(2) provides that if an overall foreign loss carried back to a pre-effective date taxable year exceeds the foreign source income in the analogous category for the carry back year, the remaining loss shall be allocated against U.S. source income as set forth in §1.904(f)-3. An addition to an overall foreign loss account resulting from the carry back of a net operating loss shall be treated as having been incurred by the taxpayer in the year in which the loss arose and shall be subject to recapture pursuant to section 904(f) as in effect for post-effective date years.

Paragraph (c)(3) provides that to the extent that an overall foreign loss carried back as part of a net operating loss exceeds the separate limitation income to which it is allocated and the U.S. source income of the taxpayer for the taxable year, the loss shall be allocated pro rata to other separate limitation income of the taxpayer for the taxable year. However, there shall be no recharacterization of separate limitation income pursuant to section 904(f)(5) as a result of the allocation of the net operating loss to other separate limitation income of the taxpayer.

Paragraph (d) provides that for taxable years beginning after December 31, 1986, and before January 1, 1991, the rules set forth in §1.904(f)-6 shall apply for purposes of recapturing general limitation and foreign oil related income (FORI) overall foreign losses incurred in taxable years beginning before January 1, 1983 (pre-1983). For taxable years beginning after December 31, 1990, the rules set forth in §1.904(f)-13T shall apply for purposes of recapturing pre-1983 general limitation and FORI overall foreign losses.

Paragraph (e) provides that the rules set forth in paragraph (a)(2) shall apply for purposes of recapturing overall foreign losses incurred in taxable years beginning before January 1, 1983, that were computed on a combined basis in accordance with §1.904(f)-1(c)(1).

NONAPPLICABILITY OF EXECUTIVE ORDER 12291

The Treasury Department has determined that these temporary regulations are not subject to review under Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required.

SPECIAL ANALYSES

A general notice of proposed rulemaking is not required by 5 U.S.C. 553(b) for temporary regulations. Accordingly, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply and no Regulatory Flexibility Analysis is required for this rule.

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

INCOME TAX REGULATIONS
(26 CFR Part 1)

Paragraph 1. The authority for Part 1 continues to read in part:

Authority: 26 U.S.C. 7805. ***

Par. 2. New §1.904(f)-13T is added immediately after §1.904(f)-6. Sections 1.904(f)-7 through §1.904(f)-12 are reserved. The added section reads as follows:

§1.904(f)-13T Transition rules.

(a) *Recapture in years beginning after December 31, 1986, of overall foreign losses incurred in taxable years beginning before January 1, 1987*—(1) *In general.* If a taxpayer has a balance in an overall foreign loss account at the end of its last taxable year beginning before January 1, 1987 (pre-effective date years), the amount of that balance shall be recaptured in subsequent years by recharacterizing income received in the income category described in section 904(d) as in effect for taxable years beginning after December 31, 1986 (post-effective date years), that is analogous to the income category for which the overall foreign loss account was established, as follows:

(i) Interest income as defined in section 904(d)(1)(A) as in effect for pre-effective date taxable years is analogous to passive income as defined in section 904(d)(1)(A) as in effect for post-effective date years;

(ii) Dividends from a DISC or former DISC as defined in section 904(d)(1)(B) as in effect for pre-effective date taxable years is analogous to dividends from a DISC or former DISC as defined in section 904(d)(1)(F) as in effect for post-effective date taxable years;

(iii) Taxable income attributable to foreign trade income as defined in section 904(d)(1)(C) as in effect for pre-effective date taxable years is analogous to taxable income attributable to foreign trade income as defined in section 904(d)(1)(G) as in effect for post-effective date years;

(iv) Distributions from a FSC (or former FSC) as defined in section 904(d)(1)(D) as in effect to pre-effective date taxable years is analogous to distributions from a FSC (or former FSC) as defined in section 904(d)(1)(H) as in effect for post-effective date taxable years;

(v) For general limitation income as described in section 904(d)(1)(E) as in effect for pre-effective date taxable years, see special rule in paragraph (a)(2) of this section.

(2) *Rule for general limitation losses*—(i) *In general.* Overall foreign losses incurred in the general limitation category of section 904(d)(1)(E), as in effect for pre-effective date taxable years, that

are recaptured in post-effective date taxable years shall be recaptured from the taxpayer's general limitation income, financial services income, shipping income, and dividends from each noncontrolled section 902 corporation. If the sum of the taxpayer's general limitation income, financial services income, shipping income and dividends from each noncontrolled section 902 corporation for a taxable year subject to recapture exceeds the overall foreign loss to be recaptured, then the amount of each type of separate limitation income that will be treated as U.S. source income shall be determined as follows:

Overall foreign loss subject to recapture × Amount of income in each separate category from which *the loss may be recaptured* Sum of income in all separate categories from which the loss may be recaptured.

This allocation shall be made after application of section 905(f)(5).

(ii) *Exception.* If a taxpayer can demonstrate to the satisfaction of the Internal Revenue Service that an overall foreign loss in the general limitation category of section 904(d)(1)(E), as in effect for pre-effective date taxable years, is attributable, in sums certain, to one or more separate categories of section 904(d)(1), as in effect for post-effective date taxable years, then the taxpayer may recapture the loss (in the amounts demonstrated) from those separate categories only.

(3) *Priority of recapture of overall foreign losses incurred in pre-effective date taxable years.* An overall foreign loss incurred by a taxpayer in pre-effective date taxable years shall be recaptured to the extent thereof before the taxpayer recaptures an overall foreign loss incurred in a post-effective date taxable year.

(4) *Examples.* The following examples illustrate the application of paragraph (a).

Example (1). X corporation is a domestic corporation which operates a branch in Country Y. For its taxable year ending December 31, 1988, X has $800 of financial services income, $100 of general limitation income and $100 of shipping income. X has a balance of $100 in its general limitation overall foreign loss account which resulted from an overall foreign loss incurred during its 1986 taxable year. X is unable to demonstrate to which of the income categories set forth in section 904(d)(1) the loss is attributable. In addition, X has a balance of $100 in its shipping overall foreign loss account attributable to a shipping loss incurred during its 1987 taxable year. X has no other overall foreign loss accounts. Pursuant to section 904(f)(1), the full amount in each of X corporation's overall foreign loss accounts is subject to recapture since $200 (the sum of those amounts) is less than 50% of X's foreign source taxable income for its 1988 taxable year, or $500. X's overall foreign loss incurred during its 1986 taxable year is recaptured before the overall foreign loss incurred during its 1987 taxable year as follows: $80 ($100 × 800/1000) of X's financial services income, $10 ($100 × 100/1000) of X's general limitation income, and $10 ($100 × 100/1000) of X's shipping income will be treated as U.S. source income. The remaining $90 of X corporation's shipping income will be treated as U.S. source income for the purpose of recapturing X's $100 overall foreign loss attributable to the shipping loss incurred in 1987. $10 remains in X's shipping overall foreign loss account for recapture in subsequent taxable years.

Example (2). The facts are the same as in *Example (1)* except that X has $800 of financial services income, $100 of general limitation income, a $100 dividend from a noncontrolled section 902 corporation and a ($100) shipping loss for its taxable year ending December 31, 1988. Pursuant to paragraph (a)(2) of this section, the rules of section 904(f)(5) apply before recapture of overall foreign losses. Therefore, the ($100) shipping loss incurred by X will be allocated to its separate limitation income as follows: $80 ($100 × 800/1000) will be allocated to X's financial services income, $10 ($100 × 100/1000) will be allocated to its general limitation income and $10 ($100 × 100/1000) will be allocated to X's dividend from the noncontrolled section 902 corporation. Accordingly, after allocation of the 1988 shipping loss, X has $720 of financial services income, $90 of general limitation income, and a $90 dividend from its noncontrolled section 902 corporation. Pursuant to section 904(f)(1), the full amount in each of X corporation's overall foreign loss accounts is subject to recapture since $200 (the sum of those amounts) is less than 50% of X's foreign source taxable income for its 1988 taxable year, or $450. X's overall foreign loss incurred during its 1986 taxable year is recaptured as follows; $80 ($100 × 720/900) of X's financial services income, $10 ($100 × 90/900) of its general limitation income and $10 ($100 × 90/900) of its dividend from the noncontrolled section 902 corporation will be treated as U.S. source income. Accordingly, after application of section 904(f), X has $100 of U.S. source income, $640 of financial services income, $80 of general limitation income and a $80 dividend from its noncontrolled section 902 corporation for its 1988 taxable year. X must establish a separate limitation loss account for each portion of the 1988 shipping loss that was allocated to its financial services income, general limitation income and dividends from its noncontrolled section 902 corporation. X's overall foreign loss account for the 1986 general limitation loss is reduced to zero. X still has a $100 balance in its overall foreign loss account that resulted from the 1987 shipping loss.

Example (3). Y is a domestic corporation which has a branch operation in Country Z. For its 1988 taxable year, Y has $5 of shipping income, $15 of general limitation income and $100 of financial services income. Y has a balance of $100 in its general limitation overall foreign loss account attributable to its 1986 taxable year. Y has no other overall foreign loss accounts. Pursuant to section 904(f)(1), $60 of the overall foreign loss is subject to recapture since 50% of Y's foreign source income for 1988 is less than the amount of its overall foreign loss for 1986. Y can demonstrate that the entire $100 overall foreign loss was attributable to a shipping limitation loss incurred in 1986. Accordingly, only Y's $5 of shipping limitation income received in 1988 will be treated as U.S. source income. Because Y can demonstrate that the 1986 loss was entirely attributable to a shipping loss, none of Y's general limitation income or financial services income received in 1988 will be treated as U.S. source income.

Example (4). The facts are the same as in *Example (3)* except that Y can only demonstrate that $50 of the 1986 overall foreign loss account was attributable to a shipping loss incurred in 1986. Accordingly, Y's $5 of shipping limitation income received in 1988 will be treated as U.S. source income. The remaining $50 of the 1986 overall foreign loss that Y cannot trace to a particular separate limitation will be recaptured and treated as U.S. source income as follows: $43 ($50 × 100/115) of Y's financial services income will be treated as U.S. source income and $7 ($50 × 15/115) of Y's general limitation income will be treated as U.S. source income.

(b) *Treatment of overall foreign losses that are part of net operating losses incurred in pre-effective date taxable years which are carried forward to post-effective date taxable years*—(1) *Rule.* An overall foreign loss that is part of a net operating loss incurred in a pre-effective date taxable year which is carried forward, pursuant to section 172, to a post-effective date taxable year will be allocated first to income in the category analogous to the income category set forth in section 904(d) as in effect for pre-effective date taxable years in which the loss occurred. The analogous category shall be determined under the rules of paragraph (a) of this section. If the loss exceeds income in the analogous income category (or categories) to which the loss is carried, the overall foreign loss shall be allocated to other foreign source income (if any) earned by the taxpayer in the carry over year in accordance with the rules set forth in section 904(f)(5). If a loss remains after application of section 904(f)(5), the loss shall be allocated to U.S. source income, which will create an addition to the taxpayer's overall foreign loss account.

(2) *Example.* The following example illustrates the rule of paragraph (b)(1).

Example. Z is a domestic corporation which has a branch operation in Country D. For its taxable year ending December 31, 1988, Z has $100 of passive income and $200 of general limitation income. Z also has a $60 net operating loss which was carried forward pursuant to section 172 from its 1986 taxable year. The net operating loss resulted from an overall foreign loss attributable to a general limitation loss. Z can demonstrate that the loss is a shipping loss. Therefore, the net operating loss will be treated as a shipping loss for Z's taxable year. Pursuant to section 904(f)(5), the shipping loss will be allocated as follows: $20 ($60 × 100/300) will be allocated to Z's passive income and $40 ($60 × 200/300) will be allocated to Z's general limitation income. Accordingly, after application of section 904(f), Z has $80 of passive income and $160 of general limitation income for its 1988 taxable year. Although no addition to Z's overall foreign loss account for shipping income will result from the NOL carry forward, shipping income earned by Z in subsequent taxable years will be subject to recharacterization as passive income and general limitation income pursuant to the rules set forth in section 904(f)(5).

(c) *Treatment of overall foreign losses that are part of net operating losses incurred in post-effective data taxable years which are carried back to pre-effective date taxable years*—

(1) *Allocation to analogous income category.* An overall foreign loss that is part of a net operating loss incurred by the taxpayer in a post-effective date taxable year which is carried back, pursuant to section 172, to a pre-effective date taxable year shall be allocated first to income in the pre-effective date income category analogous to the income category set forth in section 904(d) as in effect for post-effective date taxable years in which the loss occurred. Except for the general limitation income category, the pre-effective date income category that is analogous to a post-effective date income category shall be determined under paragraph (a)(i) through (iv) of this section. The general limitation income category for pre-effective date years shall be treated as the income category that is analogous to the post-effective date categories for general limitation income, financial services income, shipping income, dividends from each noncontrolled section 902 corporation and high withholding tax interest income. If the net operating loss resulted from separate limitation losses in more than one post-effective date income category and more than one loss is carried back to pre-effective date general limitation income, then the losses shall be allocated to the pre-effective date general limitation income based on the following formula:

$$\text{Pre-effective date general limitation income} \times \frac{\text{Loss in each post-effective date separate limitation category that is analogous to pre-effective date } \textit{general limitation income}}{\text{Loss in all post-effective categories that are analogous to pre-effective date general limitation income.}}$$

(2) *Allocation to U.S. source income.* If an overall foreign loss is carried back to a pre-effective date taxable year and the loss exceeds the foreign source income in the analogous category for the carry back year, the remaining loss shall be allocated against U.S. source income as set forth in §1.904(f)–3. The amount of the loss that offsets U.S. source income must be added to the taxpayer's overall foreign loss account. An addition to an overall foreign loss account resulting from the carry back of a net operating loss incurred by a taxpayer in a post-effective date taxable year shall be treated as having been incurred by the taxpayer in the year in which the loss arose and shall be subject to recapture pursuant to section 904(f) as in effect for post-effective date taxable years.

(3) *Allocation to other separate limitation categories.* To the extent that an overall foreign loss that is carried back as part of a net operating loss exceeds the separate limitation income to which it is allocated and the U.S. source income of the taxpayer for the taxable year to which the loss is carried, the loss shall be allocated pro rata to other separate limitation income of the taxpayer for the taxable year. However, there shall be no recharacterization of separate limitation income pursuant to section 904(f)(5) as a result of the allocation of a net operating loss to other separate limitation income of the taxpayer.

(4) *Examples.* The following examples illustrate the rules of paragraph (c)(1).

Example (1). X is a domestic corporation which has a branch operation in Country A. For its taxable year ending December 31, 1987, X has a $60 net operating loss which is carried back pursuant to section 172 to its taxable year ending December 31, 1985. The net operating loss resulted from a shipping loss; X had no U.S. source income in 1987. X had $20 of general limitation income, $40 of DISC limitation income and $10 of U.S. source income for its 1985 taxable year. The $60 NOL is allocated first to X's 1985 general limitation income to the extent thereof ($20) since the general limitation income category of section 904(d) as in effect for pre-effective date taxable years is the income category that is analogous to shipping income for post-effective date taxable years. Therefore, X has no general limitation income for its 1985 taxable year. Next, pursuant to section 904(f) as in effect for pre-effective date taxable years, the remaining $40 of the NOL is allocated first to X's $10 of U.S. source income and then to $30 of X's DISC limitation income for its 1985 taxable year. Accordingly, X has no U.S. source income and $10 of DISC limitation income for its 1985 taxable year after allocation of the NOL. X has a $10 balance in its shipping overall foreign loss account which is subject to recapture pursuant to section 904(f) as in effect for post-effective date taxable years. X will not be required to recharacterize, pursuant to section 904(f)(5), subsequent shipping income as DISC limitation income.

Example (2). Y is a domestic corporation which has a branch operation in Country B. For its taxable year ending December 31, 1987, X has a $200 net operating loss which is carried back pursuant to section 172 to its taxable year ending December 31, 1986. The net operating loss resulted from a ($100) general limitation loss and a ($100) shipping loss. Y had $100 of general limitation income and $200 of U.S. source income for its taxable year ending December 31, 1986. The separate limitation losses are allocated pro rata to Y's 1986 general limitation income as follows: $50 of the ($100) general limitation loss ($100 × 100/200) and $50 of the ($100) shipping loss ($100 × 100/200) is allocated to Y's $100 of 1986 general limitation income. The remaining $50 of Y's general limitation loss and the remaining $50 of Y's shipping loss are allocated to Y's 1986 U.S. source income. Accordingly, Y has no foreign source income and $100 of U.S. source income for its 1986 taxable year. Y has a $50 balance in its general limitation overall foreign loss account and a $50 balance in its shipping overall foreign loss account, both of which will be subject to recapture pursuant to section 904(f) as in effect for post-effective date taxable years.

(d) *Recapture of FORI and general limitation overall foreign losses incurred in taxable years beginning before January 1, 1983.* For taxable years beginning after December 31, 1986, and before January 1, 1991, the rules set forth in §1.904(f)-6 shall apply for purposes of recapturing general limitation and foreign oil related income (FORI) overall foreign losses incurred in taxable years beginning before January 1, 1983 (pre-1983). For taxable years beginning after December 31, 1990, the rules set forth in this section shall apply for purposes of recapturing pre-1983 general limitation and FORI overall foreign losses.

(e) *Recapture of pre-1983 overall foreign losses determined on a combined basis.* The rules set forth in paragraph (a)(2) of this section shall apply for purposes of recapturing overall foreign losses incurred in taxable years beginning before January 1, 1983, that were computed on a combined basis in accordance with §1.904(f)-1(c)(1).

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved April 22, 1988.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on May 16, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 17, 1988, 53 F.R. 17461 as corrected in 53 F.R. 19775.)

Part IV.—Domestic International Sales Corporations
Subpart A.—Treatment of Qualifying Corporations

Section 993.—Definitions

26 CFR 1.993-1: Definition of qualified export receipts.

DISC; definitions; qualified export receipts. Gross receipts from the sale in 1984 of personal care products ot overseas U.S. military post and base exchanges and commissary stores are qualified export receipts under section 993(a)(1) of the Code. Rev. Rul. 73-71 is modified.

Rev. Rul. 88-11

ISSUE

Are the gross receipts of a domestic international sales corporation ("DISC") from the sale in 1984 of personal care products to commissary stores and post and base exchanges located on United States military installations in foreign countries "qualified export receipts" under section 993(a)(1) of the Internal Revenue Code of 1986?

FACTS

X, a domestic corporation, manufactures personal care products. During 1984, *X* sold these products to *Y*, a domestic corporation owned by *X* that qualified as a DISC for 1984 under section 992(a) of the Code. *Y* resold the product to post and base exchanges and commissary stores located on United States military installations in foreign countries. The products were "export property" within the meaning of section 993(c).

LAW AND ANALYSIS

Section 993(a)(1) of the Code defines the "qualified export receipts" of a DISC to include gross receipts from the sale of export property. Section 993(a)(2)(C) provides in part that the Secretary may exclude from qualified export receipts the receipts of a DISC from the sale of export property for the use of the United States or any instrumentality thereof, where the use of the property is required by law or regulations.

Rev. Rul. 73-71, 1973-1 C.B. 361, considers whether receipts from a DISC's sale of export property to the Department of Defense for resale at overseas post and base exchanges and commissaries constitute qualified export receipts. The ruling holds that the post and base exchange receipts are qualified export receipts, but the commissary receipts are not because the Department of Defense purchases commissary property using appropriated funds that are subject to the Armed Services Procurement Regulations. The ruling does not cite a provision of those regulations requiring the use of the property.

Section 1.993-1(j)(4)(i) of the Income Tax Regulations, promulgated after Rev. Rul. 73-71 was issued, provides that receipts from a DISC's sale of export property to the Department of Defense for overseas use are not qualified export receipts if the property is purchased from appropriated funds that are subject to any provisions of the Armed Forces Procurement Regulations, or of any Department of Defense appropriations act, that restricts use of the funds to the procurement of items that are grown, reprocessed, reused, or produced in the United States. No law or regulation applicable to the commissary sales contains this restriction; in fact, the Armed Forces Procurement Regulations explicitly exempt property purchased for commissary resale from any such requirement. *See* 32 C.F.R. section 6-103.7 (1984). The portion of Rev. Rul. 73-71 dealing with commissary sales is therefore inconsistent with section 1.993-1(j)(4)(i) of the Income Tax Regulations.

HOLDING

Y's gross receipts from the sale in 1984 of personal care products to overseas United States military post and base exchanges and commissary stores are qualified export receipts under section 993(a)(1) of the Code.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 73-71 is modified.

Subchapter O.—Gain or Loss on Disposition of Property
Part II.—Basis Rules of General Application

Section 1012.—Basis of Property—Cost

26 CFR 1.1012-1: Basis of property.

In order to determine the basis of each item in an investment unit, consisting of a share of common stock and a separately tradeable contingent payment right, the purchase price of the unit must be allocated between the share of common stock and the contingent payment right on the basis of the fair market value of each on the date of issuance. See Rev. Rul. 88-31, page 302.

Part III.—Common Nontaxable Exchanges

Section 1032.—Exchange of Stock for Property

If a corporation issues an investment unit, consisting of a share of common stock and a contingent payment right that for federal income tax purposes is a cash settlement put option, it recognizes no gain or loss on the repurchase (including payment on the right) or the lapse of the right. See Rev. Rul. 88-31, page 302.

Section 1033.—Involuntary Conversions

26 CFR 1.1033(a)-2: Involuntary conversion into similar property, into money or into dissimilar property.

Federal income tax consequences of an election under section 1033 of the Code pursuant to section 1071 where qualified replacement property is not obtained by the taxpayer within the time prescribed by section 1033(a). See Rev. Rul. 88-39, page 299.

Section 1059.—Corporate Shareholder's Basis in Stock Reduced by Nontaxed Portion of Extraordinary Dividends

Election; fair market value; corporations; aggregation of dividends. For purposes of the dividend aggregation rules in section 1059(c)(3)(A) and 1059(c)(3)(B) of the Code, rules are provided for determining the fair market value of stock if a corporate shareholder makes the election under section 1059(c)(4).

Rev. Rul. 88-49

ISSUE

If a corporate shareholder makes the election under section 1059(c)(4) of the Internal Revenue Code to substitute the fair market value of stock as of the day before the ex-dividend date for the shareholder's adjusted basis in the stock in determining whether a dividend is "extraordinary," how is the fair market value determined in situations to which the dividend aggregation rules in section 1059(c)(3)(A) and 1059(c)(3)(B) apply?

FACTS

Situation 1.

On November 30, 1986, corporation *W* purchased common stock in corporation *X* for $90 a share. During 1987, *X* made dividend distributions, as shown in Table 1, which *W* received. On July 1, 1987, *W* sold its shares of *X* stock for $90.20 a share. *W* made the election under section 1059(c)(4) of the Code to substitute the fair market value of the *X* stock for *W*'s adjusted basis in that stock in determining whether the aggregated dividend is an extraordinary dividend.

Table 1

Amount of Dividend	Declaration Date	Payment Date	Ex-Dividend Date	FMV on Day Before Ex-Dividend Date
$5.00	February 1, 1987	March 31, 1987	March 1, 1987	$100
$4.80	April 1, 1987	May 31, 1987	May 1, 1987	$ 95

Situation 2.

On November 30, 1986, corporation *Y* purchased common stock in corporation *Z* for $90 a share. During 1987, *Z* made dividend distributions, as shown in Table 2, which *Y* received. On December 1, 1987, *Y* sold its shares of *Z* stock for $80 a share. *Y* made the election under section 1059(c)(4) of the Code to substitute the fair market value of the *Z* stock for *Y*'s adjusted basis in the stock in determining whether the dividends are extraordinary.

Table 2

Amount of Dividend	Declaration Date	Payment Date	Ex-Dividend Date	FMV on Day Before Ex-Dividend Date
$7.00	February 1, 1987	March 31, 1987	March 1, 1987	$99
$6.00	June 1, 1987	July 31, 1987	July 1, 1987	$92
$6.00	October 1, 1987	November 30, 1987	November 1, 1987	$86

Situation 3.

The facts are the same as in *Situation 2* except that *Y* did not sell its *Z* stock on December 1, 1987, and, as shown in Table 3, in the spring of 1988, *Z* made an additional dividend distribution, which *Y* received. On May 1, 1988, *Y* sold its shares of *Z* stock for $103 a share. *Y* made the election under section 1059(c)(4) of the Code to substitute the fair market value of the *Z* stock for *Y*'s adjusted basis in the stock in determining whether the dividends are extraordinary.

Table 3

Amount of Dividend	Declaration Date	Payment Date	Ex-Dividend Date	FMV on Day Before Ex-Dividend Date
$7.00	February 1, 1987	March 31, 1987	March 1, 1987	$ 99
$6.00	June 1, 1987	July 31, 1987	July 1, 1987	$ 92
$6.00	October 1, 1987	November 30, 1987	November 1, 1987	$ 86
$7.00	March 1, 1988	April 30, 1988	April 1, 1988	$120

LAW AND ANALYSIS

Section 1059(a)(1) of the Code, as amended by section 614(a)(1) of the Tax Reform Act of 1986 (1986 Act), 1986-3 (Vol. 1) C.B. 168, provides that, in general, if a corporation receives an extraordinary dividend with respect to any share of stock and such corporation has not held such stock for more than 2 years before the dividend announcement date, the basis of such corporation in such stock shall be reduced (but not below zero) by the nontaxed portion of the dividend.

Section 1059

Under section 1059(b) of the Code, the nontaxed portion of any dividend generally equals the amount of any deduction allowable with respect to such dividend under section 243, 244, or 245.

Under section 1059(c)(1) of the Code, the term "extraordinary dividend" generally means any dividend with respect to a share of stock if the amount of the dividend equals or exceeds the "threshold percentage" (5 percent for preferred stock, 10 percent otherwise, as specified in section 1059(c)(2)) of the taxpayer's adjusted basis in the share of stock.

Under section 1059(c)(3)(A) of the Code, all dividends that are received by a taxpayer with respect to any share of stock and that have ex-dividend dates within the same period of 85 consecutive days are treated as one dividend. Under section 1059(c)(3)(B), all dividends that are received by a taxpayer with respect to any share of stock and that have ex-dividend dates during the same period of 365 consecutive days are treated as extraordinary dividends if the aggregate of the dividends exceeds 20 percent of the taxpayer's adjusted basis in the stock (determined without regard to section 1059).

Section 1059(c)(4) of the Code, as added by section 614(b) of the 1986 Act, 1986-3 (Vol. 1) C.B. 169, provides that if the taxpayer establishes to the satisfaction of the Secretary the fair market value of any share of stock as of the day before the ex-dividend date, the taxpayer may elect to apply sections 1059(c)(1) and (3) by substituting this value for the taxpayer's adjusted basis.

Rev. Proc. 87-33, 1987-2 C.B. 402, provides guidance to corporate shareholders on how to establish the fair market value of stock for purposes of the election under section 1059(c)(4) of the Code.

Section 1059(d)(6) of the Code defines the term "dividend announcement date," with respect to any dividend, as the date on which the corporation declares, announces, or agrees to the payment of the dividend, whichever is the earliest.

Under section 614(f) of the 1986 Act, 1986-3 (Vol. 1) C.B. 171, section 1059(c)(4) of the Code generally applies to dividends declared after July 18, 1986, in tax years ending after that date.

Section 1059 was added to the Code by section 53(a) of the Tax Reform Act of 1984, 1984-3 (Vol. 1) C.B. 73. Congress was concerned with several types of tax-motivated transactions that were encouraged primarily by the fact that a corporation owning stock in another corporation generally is allowed a dividend deduction (equal to 80 percent under section 243(a)(1), 85 percent prior to the amendment by section 611(a)(1) of the 1986 Act) of the amount of any dividends received with respect to that stock. A corporation would buy stock in another corporation (before the ex-dividend date) in anticipation of receiving a large (extraordinary) dividend that would be eligible for the dividends received deduction and that would reduce the value of the stock after receipt of the dividend. After receiving the dividend, the corporation would then sell the stock and claim the loss resulting from the decline in value of the stock as short-term capital loss that could offset unrelated short-term capital gain. *See* S. Rep. No. 169, 98th Cong., 2d Sess. 170 (1984).

Congress enacted section 1059 of the Code to prevent this type of transaction and similar tax-motivated transactions. As orginally enacted, section 1059 provided generally that if a corporate shareholder received an extraordinary dividend on stock and disposed of the stock without having held it for more than 1 year, then the basis of the stock must be reduced by the nontaxed portion of the dividend.

Section 1059 of the Code proved to be an inadequate deterrent to the tax-motivated transactions at which the provision was directed because, simply by holding stock beyond the 1-year holding period, taxpayers were able to obtain the tax benefits that Congress intended to curtail. Therefore, in the 1986 Act Congress amended section 1059 by providing for a holding period beginning 2 years before the dividend announcement date, rather than the original holding period extending 1 year after the date of acquisition.

Congress decided, however, that it was appropriate:

> to mitigate the application of [the modification of the holding period] to extraordinary dividends as defined under present law where the shareholder can demonstrate that the stock has significantly appreciated since the shareholder's original investment. Accordingly, the [Senate] bill provides an alternative test for whether a dividend is extraordinary based on the fair market value of the stock, but only in situations in which the taxpayer is able to establish the fair market value of the stock to the satisfaction of the Commissioner.

S. Rep. No. 313, 99th Cong., 2d Sess. 250 (1986), 1986-3 (Vol. 3) C.B. 250.

The above-described legislative history indicates that although section 1059 of the Code was enacted as an anti-abuse provision, the legislative intent of the fair market value election in section 1059(c)(4) was to provide relief from the basis reduction rule of section 1059(a)(1) in situations where the fair market value of stock has significantly appreciated.

Section 1059(c)(3)(A) of the Code treats dividends received by a taxpayer within the same 85-day aggregation period as one dividend. By contrast, section 1059(c)(3)(B) treats dividends received by a taxpayer within the 365-day aggregation period as separate dividends, although the amounts of those dividends are aggregated for purposes of making the extraordinary dividend determination. Because the aggregation periods operate differently, different rules are appropriate for determining the fair market value of stock under the two aggregation rules.

The proper value to use in the case of the 85-day aggregation period is the fair market value of the stock on the day before the first ex-dividend date. Under section 1059(c)(3)(A) of the Code, multiple dividends within the aggregation period should have the same tax result as a single dividend for the aggregated amount. A single dividend has only one ex-dividend date, and the value of the day before that ex-dividend date has not yet been reduced by the stock going ex-dividend. Analogously, because section 1059(c)(3)(A) treats multiple dividends as a single dividend, only one ex-dividend date in the 85-day aggregation period should be used in applying the test, and the value taken into account should be unaffected by the stock being ex-dividend with respect to any portion of the aggregated dividends. The only date the value of the stock is unaffected by the payment of the dividends is the day before the first ex-dividend date. Moreover, if favorable market conditions cause the fair market value of the stock to increase, using a value other than that on the day before the first ex-dividend date, such as the highest value, could result in an extraordinary dividend being cured by a subsequent dividend. In other words, the aggregated dividend tested against the higher value might not be extraordinary, even though the first dividend, standing alone, would have been extraordinary. There is no reason to believe that section 1059(c)(3)(A) contemplates the possibility of such a cure.

With respect to the 365-day aggregation period, the Code does not treat multiple dividends as one. Rather, the aggregate amount of dividends is used to determine whether each dividend is extraordinary. Because the election in section 1059(c)(4) is designed to mitigate the effects of appreciation, the rule for determining fair market value must take into account that over a 365-day period there is a greater likelihood of appreciation in the value of the stock than over the 85-day period. The fair market value on the day before the first ex-dividend date will not reflect subsequent appreciation in the value of the stock within the 365-day aggregation period. However, the use of a weighted average of the fair market values of the stock on the days before the ex-dividend dates most accurately reflects the value of the stock when the multiple dividends are made. Therefore, for purposes of the 365-day aggregation period of section 1059(c)(3)(B), corporate shareholders making the section 1059(c)(4) election must use the weighted average of the fair market values of the stock on the days before the ex-dividend dates.

HOLDINGS

Situation 1. Because the February 1, 1987, and April 1, 1987, dividends have ex-dividend dates within the same period of 85 consecutive days, section 1059(c)(3)(A) of the Code requires that the two dividends be treated as one dividend in the amount of $9.80. In determining whether that dividend is an extraordinary dividend within the meaning of section 1059(c), *W* must use the fair market value of the *X* stock ($100) on February 28, 1987, because that fair market value was the fair market value of the *X* stock on the day before the first ex-dividend date in the aggregation period. Because the amount of the aggregated dividend ($9.80) does not equal to exceed 10 percent of the fair market value ($100) of the *X* stock on February 28, 1987, the dividend is not an extraordinary dividend under section 1059(c).

Situation 2.

Because the February 1, 1987, June 1, 1987, and October 1, 1987, dividends have ex-dividend dates within the same period of 365 consecutive days, section 1059(c)(3)(B) of the Code requires that the amounts of the three dividends be aggregated. In determining whether the three dividends are extraordinary dividends, *Y* must use the weighted average of the fair market values of the *Z* stock on the days before the ex-dividend dates. Because the aggregated amount of the three dividends ($19) exceeds 20 percent of that weighted average ($92.68, which was derived as [(7 × $99) + (6 × $92) + (6× $86)]/19, the three dividends are treated as extraordinary dividends. Moreover, because *Y* did not hold the *Z* stock for more than 2 years before the dividend announcement dates, *Y* must reduce its basis in the *Z* stock by the nontaxed portion of the dividends.

Situation 3.

Because, as in *Situation 2*, the February 1, 1987, June 1, 1987, and October 1, 1987, dividends have ex-dividend dates within the same period of 365 consecutive days, and because the aggregated amount of these dividends exceeds 20 percent of the weighted average of the fair market value of the *Z* stock on the days before the three ex-dividend dates, the three dividends are extraordinary.

Section 1059(c)(3)(B) of the Code requires that the amounts of the June 1, 1987, October 1, 1987, and March 1, 1988, dividends be aggregated to test for extraordinary dividends, because these dividends also have ex-dividend dates within a period of 365 consecutive days. Every 365 day period must be tested independently. The aggregated amount of these three dividends ($19) does not exceed 20 percent of the weighted average fair market value of $100.42 ([(6 × $92) + (6 × $86) + (7 × $120)]/19). However, because the June 1, 1987, and October 1, 1987, dividends are already extraordinary dividends, these two dividends remain extraordinary. Only the March 1, 1988, dividend is not an extraordinary dividend.

Part V.—Changes to Effectuate F.C.C. Policy

Section 1071.—Gain From Sale or Exchange to Effectuate Policies Of F.C.C.

26 CFR 1.1071-2: Nature and effect of election.
(Also Section 1033; 1.1033(a)-2.)

Sale to effectuate policies of F.C.C.; elections. A taxpayer who elected on a timely filed return the provisions of section 1033 of the Code pursuant to section 1071(a) and subsequently was unable to acquire qualified replacement property within the time prescribed by section 1033(a) may not then elect on a return for a subsequent year to reduce the basis of other depreciable property pursuant to section 1071(a) and section 1.1071-3 of the regulations.

Rev. Rul. 88-39

ISSUE

If a taxpayer elected under section 1071(a) of the Internal Revenue Code to treat the sale of a broadcasting station as an involuntary conversion within the meaning of section 1033(a) but was unable to acquire replacement property, may the taxpayer subsequently elect to defer recognition of the gain on such sale by reducing the basis of other depreciable property in accordance with the regulations under section 1071(a)?

FACTS

The taxpayer, a domestic corporation, was required by the Federal Communications Commission (FCC) to sell a broadcasting station. The taxpayer received a certificate from the FCC stating that the sale was necessary to effectuate a change in policy of the FCC with respect to ownership or control of broadcasting stations.

The taxpayer sold the station in 1984. When the taxpayer filed its federal income tax return for 1984, it attached a statement, in duplicate, electing under section 1071(a) of the Code to treat the sale as an involuntary conversion under section 1033. The statement was signed in the manner required by section 1.1071-4(a) of the Income Tax Regulations. The taxpayer also attached a copy of the certificate received from the FCC.

Unable to find qualified replacement property, the taxpayer, in its 1986 return, sought to elect under section 1071(a) of the Code and section 1.1071-3 of the regulations to reduce the basis of depreciable property that it had owned immediately after the 1984 sale or had acquired in the year of sale.

LAW AND ANALYSIS

Section 1071(a) of the Code provides that if the sale or exchange of property (including stock in a corporation) is certified by the FCC to be necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the FCC with respect to the ownership and control of radio broadcasting stations, such sale or exchange, upon election by the taxpayer, shall be treated as an involuntary conversion within the meaning of section 1033.

Further, section 1071(a) of the Code and section 1.1071-3(a)(1) of the regulations provide that the part of the gain, if any, on such sale or exchange to which section 1033 is not applied shall nevertheless not be recognized, if the taxpayer so elects, to the extent that that part of the gain is applied to reduce the basis for determining gain or loss on sale or exchange of property of a character subject to the allowance for depreciation under section 167 remaining in the hands of the taxpayer immediately after the sale or exchange, or acquired in the same tax year. Any election made by the taxpayer under section 1071 shall be made by a statement to that effect in the return for the tax year in which the sale or exchange takes place, and such election shall be binding for the tax year and all subsequent tax years.

Section 1.1071-2(a) of the regulations states:

> (1) A taxpayer entitled to the benefits of section 1071 in respect of a sale or exchange of property may elect—
>
> (i) To treat such sale or exchange as an involuntary conversion under the provisions of section 1033; or
>
> (ii) To treat such sale or exchange as an involuntary conversion under the provisions of section 1033, and in addition elect to reduce the basis of property, in accordance with the regulations prescribed in [section] 1.1071-3, by all or part of the gain that would otherwise be recognized under section 1033; or
>
> (iii) To reduce the basis of property, in accordance with the regulations prescribed in [section] 1.1071-3, by all or part of the gain realized upon the sale or exchange.

Section 1.1071-2(a)(2) of the regulations states that the effect of section 1.1071-2(a)(1) is, in general, to grant the taxpayer an election to treat the proceeds of the sale or exchange as the proceeds of an involuntary conversion subject to the provisions of section 1033 of the Code, and a further election to reduce the basis of certain property owned by the taxpayer by the amount of the gain realized upon the sale or exchange to the extent of the portion of the proceeds which is not treated as the proceeds of an involuntary conversion.

Section 1.1071-3(a)(1) of the regulations provides that the election to reduce basis under section 1071 of the Code applies only with respect to the cost or other basis of property that is of a character subject to the allowance for depreciation under section 167, and is either in the hands of the taxpayer at the time of the sale or exchange or acquired by the taxpayer in the same taxable year as the year of the sale or exchange.

Section 1.1071-4(a) of the regulations provides that an election under section 1071 of the Code to reduce the basis of property and an election under such section to treat the sale or exchange as an involuntary conversion under section 1033 may be exercised independently of each other. An election under section 1071 must be filed with the return for the tax year in which the sale or exchange occurs. Where practicable, the certificate of the FCC should be filed with the election.

Section 1033(a) of the Code provides that if property is involuntarily converted into money and the taxpayer, during the period specified, purchases other property similar or related in service or use to the property so converted, then at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion exceeds the cost of such other property. As a general rule the converted property must be replaced before the expiration of two years after the close of the first tax year in which any part of the gain upon the conversion is realized.

In *Cloutier v. United States*, 709 F.2d 480 (7th Cir. 1983), the court held that an election pursuant to section 1071 of the Code may not be made on an amended federal income tax return. The Internal Revenue Service agrees with this holding. *See* Rev. Rul. 79-277, 1979-2 C.B. 300. However, in dicta, the *Cloutier* opinion indicates that a taxpayer who makes a valid election under section 1071 to defer the recognition of gain under section 1033 but is unable to find suitable replacement property can change its election and instead defer the recognition of gain by reducing the basis of depreciable property in accordance with section 1.1071-3 of the regulations. 709 F.2d at 484-85. The Service disagrees with this conclusion. This revenue ruling explains the Service's position that a taxpayer cannot make a subsequent election to reduce basis.

Section 1071 of the Code provides two methods by which a taxpayer may defer the gain resulting from the sale or exchange of property if such sale or exchange is appropriately certified by the FCC. First, the taxpayer may treat the sale or exchange as an involuntary conversion under section 1033 and determine the amount of gain to be recognized under the provisions of section 1033, as modified by section 1071, together with the regulations prescribed under such sections. Second, the taxpayer may elect to defer the gain by reducing the basis of qualified depreciable property by the amount of such gain. Section 1071(a) and the regulations thereunder provide, however, that such other property must be in the hands of the taxpayer immediately after the sale or exchange, or acquired in the same tax year. In addition, the regulations state that in the case of property in the hands of the taxpayer, the time of reduction of the basis is the date of the sale or exchange; in all other cases the time of reduction of the basis is the date of acquisition. *See* section 1.1071-3(a)(1). Thus, in no event could the time of the reduction in basis be later than the end of the tax year in which the sale or exchange occurred.

Section 1071(a) of the Code and the regulations thereunder further provide that an election under that section is binding for the tax year of the sale or exchange and all subsequent tax years. The regulations thereunder state that the alternative elections under section 1071 to reduce the basis of property or to treat the sale or exchange as an involuntary conversion under section 1033 may be exercised independently of each other. Section 1.1071-4(a) of the regulations. The legislative history of section 112(m) of the Internal Revenue Code of 1939 (the predecessor of section 1071) indicates that the alternative elections are "separate and distinct elections which may be exercised independently of each other. However, either election once made is binding as to the particular sale or exchange for the taxable year and all subsequent taxable years." H.R. Conf. Rep. No. 1079, 78th Cong., 2d Sess. 50 (1944), 1944 C.B. 1059, 1066.

The last sentence discussing this issue in the conference committee report is particularly relevant. It states:

> An election to reduce the basis of property remaining in the hands of the taxpayer may not be made with respect to any portion of the proceeds of the sale or exchange used to establish a replacement fund pursuant to an election to have the benefits of section 112(f) [the predecessor of section 1033] even though the entire amount of such fund is not subsequently expended in the acquisition of property similar or related in service or use to the property disposed of.

H.R. Conf. Rep. No. 1079 at 50, 1944 C.B. at 1066.

Thus, Congress intended that if a taxpayer elected to treat a sale or exchange as an involuntary conversion and it was necessary to establish a replacement fund because the property could not be replaced immediately, then any unexpended portions of the fund could not be subsequently used to reduce the basis of property remaining in the hands of the taxpayer. Section 1033 of the Code no longer requires the use of a replacement fund. This does not, however, diminish the significance of the legislative intent to prohibit the consecutive use of section 1033 and the basis reduction provisions of section 1071 on the same proceeds from a qualifying sale or exchange. Such a conclusion is supported by the regulations, which, as noted above, require that the reduction in basis take place no later than the end of the tax year in which the sale or exchange occurs.

An example in section 1.1071-2(c) of the regulations illustrates how a taxpayer, with respect to a single transaction, can avail itself of the two elections provided under section 1071 of the Code. In the example, unlike the facts presented by this revenue ruling, the taxpayer acquired qualified replacement property under section 1033 prior to filing its return for the taxable year in which the sale or exchange eligible for FCC certification took place. The example demonstrates how, on the return for the taxable year in which the sale or exchange takes place, the taxpayer may allocate the sale or exchange proceeds between section 1033 replacement property and basis reduction under section 1.1071-3 of the regulations.

In addition, with respect to a single transaction, a taxpayer may also use a combination of the two elections provided in section 1071 of the Code, even though the taxpayer does not acquire replacement property under section 1033 of the Code prior to filing its return for the tax year in which the sale or exchange took place. On this return, the taxpayer may both elect to reduce the basis of assets by a specified amount of the gain realized on the sale or exchange and also elect to treat the sales proceeds, less the amount of gain so specified, as the proceeds of an involuntary conversion. By acquiring qualifying replacement property within the time period prescribed by section 1033(a)(2), the taxpayer may then avoid recognition of some or all of the part of the gain that was realized on the sale or exchange and that was not applied to reduce basis. No further basis reduction is then available for the amount that was so treated as the proceeds of an involuntary conversion but that was not used to purchase replacement property within the time period prescribed by section 1033(a)(2). *See* section 1.1033(a)-2(c)(2) for regulations applicable to the remaining portion of the sales proceeds.

If a taxpayer, however, makes both elections provided for in section 1.1071-2(a)1(ii) of the regulations, then the elections must be made on its return for the tax year in which the property is sold or exchanged, and the taxpayer must specify in those elections the amount that is subject to each. Even though the taxpayer cannot determine until the end of the 2-year replacement period the amount of gain that section 1033 of the Code requires to be recognized rather than deferred, specification of the amount subject to each of the elections may not be postponed until that time. That is, a taxpayer that makes both elections under section 1071 must make the elections on its return for the tax year of the sale or exchange, must identify in that return the amounts subject to each election, and may not defer until the end of the replacement period the specification of those amounts. A taxpayer attempting to defer that specification would be attempting to elect, with respect to the same proceeds, both involuntary conversion treatment and basis reduction. This would be contrary to the congressional intent that these are separate and independent elections.

HOLDING

If a taxpayer elected on a timely filed return the provisions of section 1033 of the Code pursuant to section 1071(a) and subsequently was unable to acquire qualified replacement property within the time prescribed by section 1033(a), the taxpayer may not then elect on a return for a subsequent year to reduce the basis of other depreciable property pursuant to section 1071(a) and section 1.1071-3 of the regulations. In addition, under *Cloutier* and Rev. Rul. 79-277, such an election to reduce basis cannot be made on an amended return for the tax year in which the sale or exchange took place.

Part VII.—Wash Sales; Straddles

Section 1092.—Straddles

26 CFR 1.1092(b)-2T: Treatment of holding periods and losses with respect to straddle positions.

If a holder of an investment unit, consisting of a share of common stock and a contingent payment payment right that for federal income tax purposes is a cash settlement put option, realizes a loss on the sale of the right, recognition of the loss generally is deferred until the share of stock is sold. See Rev. Rul. 88-31, below.

Subchapter P.—Capital Gains and Losses
Part III.—General Rules for Determining Capital Gains and Losses

Section 1222.—Other Terms Relating to Capital Gains and Losses

If a taxpayer holds a corporation's contingent payment right that for federal income tax purposes is a cash settlement put option, any gain or loss realized by the holder on the sale, lapse, or exercise of the right is recognized as short- or long-term capital gain or loss, depending on the holding period of the right. See Rev. Rul. 88-31, below.

Part IV.—Special Rules for Determining Capital Gains and Losses

Sections 1234.—Options to Buy or Sell

26 CFR 1.1234-1: Options to buy or sell.
(Also Sections 1012, 1032, 1092, 1222, 1234A; 1.1012-1, 1.1092(b)-2T.)

Options; contingent payment right. If a corporation issues an investment unit consisting of a share of common stock and a contingent payment right the value of which varies inversely with the value of the stock, the contingent payment right is a cash settlement put option. The tax consequences to the corporate issuer and a holder of a unit or contingent payment right are addressed in various circumstances.

Rev. Rul. 88-31

ISSUES

1. If a corporation issues investment units such that each unit consists of a share of its common stock and a separately tradeable contingent payment right the value of which varies inversely with the value of the stock, what is the proper characterization of the contingent payment right for federal income tax purposes?

2. What are the federal income tax consequences to a taxpayer that holds both a share of the issuing corporation's common stock and a contingent payment right if the taxpayer sells the right or the share of stock, or if the taxpayer receives a payment upon maturity of the right? Alternatively, what are the tax consequences to a taxpayer that holds only a contingent payment right if the taxpayer sells the right or receives a payment upon maturity of the right?

3. What are the federal income tax consequences to the corporate issuer of the investment units upon the issuance of the units, upon a repurchase of a contingent payment right, or upon a payment by the issuer upon maturity of a right?

FACTS

X is a domestic corporation the common stock of which is widely held and publicly traded on a national securities exchange. In order to raise capital, *X* publicly issued investment units (Units), each of which consisted of one share of *X* common stock and one contingent payment right (Right). For a short period after the issuance of a Unit, the common stock and the Right were not separately transferable. Thereafter, the Right and the common stock could be traded separately on a national securities exchange.

The Units were issued for $10 each on a date when the *X* common stock was trading at $8 per share. The Rights provide that on the date (Payment Date) two years from the issue date, *X* will pay to the holder of a Right an amount (Payment) equal to $11 minus the then market price of a share of *X* common stock, subject to a maximum of twice the value, as of the Payment Date, of a share of *X* common stock. In any event, a $0.10 minimum Payment will be made in satisfaction of each Right.

Thus, under the terms of a Right, the maximum Payment that the holder of a Right may receive is $7.33, which will be received if the market price of *X* common stock on the Payment Date is $3.67. ($11 minus $3.67 equals $7.33, which does not exceed twice the value of *X* common stock ($3.67 × 2 = $7.34).) If the market price of *X* common stock on the Payment Date is less than $3.67, the holder will be limited to a payment of twice the value of the stock. Accordingly, the value of a Right varies inversely with the value of the underlying *X* common stock at *X* common stock prices between $10.90 and $3.67.

At its election, *X* can make the Payment by transferring its common stock of equal value (determined as of the Payment Date), by paying cash, or by transferring any combination of its common stock and cash. On the Payment Date, the rights of a holder of a Right will terminate without any action by the holder and will be automatically converted to the right to receive the Payment. The Payment, whether in cash, *X* common stock, or any combination thereof, will be mailed to holders of the Rights within five business days following the Payment Date.

The holder of a Right does not possess the right to vote, the right to receive dividends, the right to receive assets on liquidation of *X*, or the pre-emptive, preferential, or other right of first refusal to subscribe for or purchase stock of *X*

LAW AND ANALYSIS

1. *Characterization of the Rights*

The federal income tax consequences of the issuance of the Units, sale of a Unit or a Right, or payment, or receipt of Payment, upon maturity of a Right first depend on whether the Rights are regarded as property separate from the common stock or are regarded as an attribute of the common stock giving the holder of a Unit the right to a distribution with respect to the stock. For the Rights to be considered an attribute of the stock, the right to Payment on the Payment Date generally must be inseparable from the other rights inherent in the stock. Rev. Rul. 75-33, 1975-1 C.B. 115, concerns a contingent right that is attached to convertible preferred stock to receive additional dividends if certain events occur during a 10-year period. The ruling concludes that the contingent right is a right inherent in the stock because the right is extinguished on conversion of the preferred stock into common stock. *Compare* Rev. Rul. 78-142, 1978-1

C.B. 111 (finding a single item of property), *with* Rev. Rul. 70-108, 1970-1 C.B. 78 (finding two items of property).

In the present situation, because the Rights may be traded separately from the stock, a holder of a Right could receive the Payment on the Payment Date without owning a share of stock in *X*. The short period after issuance during which the Rights cannot be traded separately from the common stock does not significantly affect the fact that the properties generally may be traded separately. In addition, a holder of both a Right and a share of *X* stock may receive Payment on the Right without giving up the share of *X* stock. Thus, the Rights are unlike conversion rights on certain instruments, which rights are not separate from the property that may be converted pursuant to the rights. Moreover, the value of the Rights varies inversely with the value of the common stock. Accordingly, for federal income tax purposes, the Rights are property that is separate from the common stock.

In order to determine the basis of each item of separate property that comprises the Unit, the $10 purchase price of a Unit must be allocated between the share of common stock and the Right on the basis of the fair market value of each on the date of issuance. *Cf.* section (1.1012-1(d) of the Income Tax Regulations. Thus, the portion of the $10 purchase price of the Unit that is attributable to the fair market value of the common stock on the date of issuance, $8, is the cost and basis of the stock, and the balance of the purchase price, $2, is the cost and basis of the Right. Section 1012 of the Code.

The federal income tax consequences resulting from transactions involving the Rights, as property separate from the common stock, depend on the nature of these Rights.

A "put" is an option to sell specified property, including corporate stock, at a stipulated price (the strike price) on or before a specific future date. This option to sell is granted by the writer to the holder and is generally granted for consideration, such as a cash payment. *See* Rev. Rul. 78-182, 1978-1 C.B. 265. A put is distinguishable from a stock purchase right, such as a call or a warrant. The value of a stock purchase right increases as the value of the stock increases. In contrast, as the value of the underlying property decreates, the value of the put increases. Thus, there is an inverse relationship between the value of a put and the value of the underlying property.

Section 1234(c)(2)(A) of the Code provides that, for purposes of section 1234(a) and (b), a cash settlement option shall be treated as an option to buy or sell property. Section 1234(c)(2)(B) defines a cash settlement option as any option that on exercise settles in (or could be settled in) cash or property other than the underlying property. Thus, cash settlement options call for, or permit, payment of trading profits or losses rather than delivery of the underlying property.

Over a wide range of reasonably anticipated values of *X* common stock, the holder of a Right in the instant case is in an economic position identical to the holder of a put with respect to *X* common stock. This is so because, in that range, the value of a Right increases as the value of the *X* common stock decreases. Further, the holder of a Right has a right to receive property based on the selling price of the *X* stock on a specific future date which right was granted for consideration. The fact that the holder of the Right does not have to deliver the underlying property to *X* but receives the payment as if the holder had purchased the property and sold it to *X* is characteristic of a cash settlement put option. Accordingly, for federal income tax purposes, a Right is a cash settlement put option. The facts that the Payment may be made in either cash or *X* stock at the option of *X*, that the Payment is to be made on a specified date, and that the Payment is limited by a ceiling of $7.33 and a floor of $0.10 are not inconsistent with characterizing a Right as a cash settlement put option. *See* section 1234(c)(2)(B) of the Code.

2. *Tax Consequences to the Holder*

Rev. Rul. 78-182, 1978-1 C.B. at 267, holds that the cost of a put is a nondeductible capital expenditure.

Section 1234(a)(1) of the Code provides, in relevant part, that, in the case of the holder of an option to buy or sell property, the gain or loss attributable to the sale or exchange of, or loss attributable to the failure to exercise, the option is considered gain or loss from the sale or exchange of property with the same character as the property to which the option relates would have in the hands of the taxpayer. Section 1234(a)(2) provides that, if an option lapses (that is, expires without being exercised), it is deemed to have been sold or exchanged on the date it expires. Section 1234(c)(2)(A) provides that a cash settlement option is treated as an option to buy or sell property for purposes of section 1234(a) or (b). The purpose of section 1234(c)(2)(A) is "to clarify that gain or loss on the sale, exchange, lapse, or exercise of the [cash settlement] option is capital gain or loss with respect to grantors or holders." H.R. Rep. No. 861, 98th Cong., 2d Sess. 904 (1984), 1984-3 (Vol. 2) C.B. 158. Accordingly, if a cash settlement option is in fact settled in cash, the transaction is treated as a sale or exchange of the option. Thus, if the underlying property would be a capital asset in the hands of the taxpayer, gain or loss on the transaction is considered gain or loss from the sale or exchange of a capital asset.

Section 1234A of the Code provides, in relevant part, that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property (as defined in section 1092(d)(1)) which is (or on acquisition would be) a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset.

Section 1092(c)(1) of the Code provides that a "straddle" means offsetting positions with respect to personal property. Pursuant to section 1092(c)(2)(A), a taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the risk of loss from holding any position with respect to personal property by reason of holding one or more other positions with respect to personal property, whether or not of the same kind.

Section 1092(d)(2) of the Code defines a "position" as an interest, including a futures or forward contract or option, in personal property.

Section 1092(d)(1) of the Code defines the term "personal property" as any personal property of a type which is actively traded. Section 1092(d)(3)(B)(I) provides that stock is "personal property" if the stock is part of a straddle in which at least one of the offsetting positions is an option with respect to that stock or substantially similar stock or securities.

Section 1092(a)(1)(A) of the Code provides that any loss with respect to one or more positions shall be taken into account for any taxable year only to the extent that the amount of such loss (the deferred loss) exceeds the unrecognized gain (if any) with respect to one or more positions which were offsetting positions with respect to one or more positions from which the loss arose. Section 1092(a)(1)(B) states that any loss which may not be taken into account under section 1092(a)(1)(A) for any taxable year can be carried forward to the succeeding taxable year, subject to the limitations of section 1092(a)(1)(A). Section 1092(a)(3)(A) provides that for any position held by the taxpayer at the close of the taxable year, unrecognized gain is the amount of gain that would be taken into account if the position were sold at its fair market value on the last business day of the taxable year.

Section 1.1092(b)-2T(a)(1) of the temporary Income Tax Regulations provides that a taxpayer's holding period for any position that is part of a straddle does not begin earlier than the date that the taxpayer no longer holds directly or indirectly (through a related person or flow-through entity) an offsetting position with respect to that position. However, pursuant to section 1.1092(b)-2T(a)(2), this holding period rule does not apply to a position that, before a straddle that includes such position is established, is held by a taxpayer for the long-term capital gains holding period (or longer).

Section 1.1092(b)-2T(b)(1) of the temporary regulations provides that a loss sustained on the disposition of one or more positions of a straddle is treated as long-term capital loss if: (i) on the date the taxpayer entered into the loss position, the taxpayer held directly or indirectly (through a related person or flowthrough entity) one or more offsetting positions with respect to the loss position; and (ii) all gain or loss with respect to one or more positions in the straddle would be treated as long-term capital gain or loss if such positions were disposed of on the day the taxpayer entered into the loss position.

In the present situation, as concluded above, a Right is a cash settlement put option, which is treated as an "option to buy or sell property" under section 1234(c)(2) of the Code. Therefore, a Right is an option within the meaning of section 1092(d)(3)(B)(i)(I). Because a Right serves to diminish substantially a stockholder's risk of loss from a decline in value of the *X* common stock, the Unit is a straddle as defined in section 1092(c)(1). A taxpayer is a holder of a straddle during the period the taxpayer holds both a Right and a share of *X* stock, regardless whether they were acquired as a Unit or separately.

For purposes of the following analysis, it is assumed that Rights or shares of *X* common stock are capital assets in the hands of the holder thereof, that the holder is not a dealer, and that no other positions offsetting to either the Rights or shares of *X* common stock are held by the holder thereof or by a related person to the holder within the meaning of section 1092(d)(4)(B) of the Code.

Sale of a Right

If a purchaser of a Unit sells the Right prior to the Payment Date, any gain or loss realized is a short-term capital gain or loss. Section 1.1092(b)-2T(a)(1) of the temporary regulations. Pursuant to section 1092(a) of the Code, if a loss is realized on the sale of the Right, recognition of the loss generally is deferred until the share of stock is sold. If, however, the loss from sale of a Right exceeds the unrecognized gain with respect to the stock, the loss can be recognized currently to the extent of the excess. The deferred loss can be carried forward to a succeeding taxable year subject to the rule set forth in section 1092(a)(1)(B). Under section 1.1092(b)-2T(a)(1), the holding period for the stock begins on the date the Right is sold.

If a taxpayer acquires only a Right and, at the time of the acquisition of the Right, the taxpayer has held a share of *X* common stock for less than the long-term capital gains holding period, or if the taxpayer acquires only a Right and then acquires a share of *X* common stock during a period less than the long-term capital gains holding period after the acquisition of the Right, the tax consequences to the taxpayer on the sale of the Right are the same as the tax consequences with respect to a taxpayer that purchased the Right, and the share of *X* common stock as a Unit.

If, at the time of the acquisition of the Right, a taxpayer has held a share of *X* common stock for the long-term capital gains holding period (or longer), any loss on the sale of the Right is a long-term capital loss. Section 1.1092(b)-2T(b)(1) of the temporary regulations. However, any gain on the sale of a Right under these circumstances is short-term capital gain. Section 1.1092(b)-2T(a)(1).

If, at the time of acquisition of a share of *X* common stock, a taxpayer has held a Right for the long-term capital gains holding period (or longer), the holding period for the Right begins on the date it was originally acquired, and any gain or loss on a sale of the Right is a long-term capital gain or loss. Section 1.1092(b)-2T(a)(2).

Lapse of a Right

If the value of the *X* common stock as of the Payment Date is $10.90 or more, a taxpayer holding a Right receives a Payment of $0.10 from X. The return of this *de minimis* amount in all events does not detract from the fact that, in substance, the Right has lapsed. The taxpayer's loss equals the amount paid for the Right less the $0.10 paid by *X*. For example, if the taxpayer acquired the Right on the issuance of the Units, the taxpayer's loss is $1.90 ($2.00 − $0.10). The characterization of the loss as short or long term and the timing of the recognition of the loss is the same in the case of a lapse of a Right as in the case of its sale, as discussed above. Section 1234A of the Code.

Receipt of Payment on the Payment Date

If a taxpayer holds a Right on the Payment Date and receives a Payment of more than $0.10, the taxpayer is treated as having exercised a cash settlement put option. As discussed above, exercise of a cash settlement option is treated as a sale or exchange of the option. Accordingly, the taxpayer realizes capital gain or loss in an amount equal to the difference between the amount of the Payment and the premium paid for the Right. The characterization of the gain or loss as short or long term and the timing of the recognition of the loss is the same in the case of a Payment as in the case of the sale of a Right, as discussed above.

If the Payment is made in *X* stock, the amount of the Payment is the fair market value of the stock. The taxpayer's basis in the *X*, stock equals the fair market value of that stock. Section 1012 of the Code. The holding period for the *X* stock begins on the day after the Payment Date. Rev. Rul. 70-598, 1970-2 C.B. 168.

Sale of Stock

If a taxpayer owns a Right and a share of *X* common stock, and sells the share of *X* common stock while retaining the Right, the characterization of the gain or loss as short or long term and the timing of the recognition of the loss on the sale of the share of *X* common stock is determined under the same principles that apply to the sale of a Right, as discussed above.

Taxpayer Acquires Only a Right

If the taxpayer acquires only a Right and either sells the Right or receives a Payment on the Payment Date, section 1092 of the Code and the regulations thereunder do not apply to the sale, lapse, or exercise of the Right. Accordingly, any gain or loss realized by the taxpayer on the sale, lapse, or exercise of a Right is recognized as a short- or long-term capital gain or loss, depending on the holding period for the Right. Section 1222.

3. *Tax Consequences to the Issuer*

If the writer of a put is also the issuer of the stock that is subject to the put, the rules applicable to a writer of a put apply, unless specific rules applying to transactions in which a corporation deals in its own stock override the rules applicable to the writer of a put.

Rev. Rul. 78-182 holds that the premium received for writing a put is not included in income at the time of receipt. Instead, it is carried in a deferred account until the writer's obligation expires through the passage of time, until the writer purchases the underlying stock pursuant to the exercise of the put, or until the writer engages in a closing transaction.

Section 1234(b)(1) of the Code provides that, in the case of a writer of an option in "property" as defined in section 1234(b)(2)(B), gain or loss from any closing transaction with respect to, and gain on lapse of, the option in property shall generally be treated as a gain or loss from the sale or exchange of a capital asset held for less than the long-term capital gains holding period. A closing transaction is defined in section 1234(b)(2)(A) as any termination of the taxpayer's obligation under an option in property other than through the exercise or lapse of the option. As discussed above, if a cash settlement option is in fact settled in cash, the transaction is treated as a sale or exchange of the option. Thus, for purposes of section 1234(b)(2)(A), cash settlement is treated as a closing transaction.

Section 1032(a) of the Code provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. Section 1032(a) further provides that no gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock (including treasury stock).

In the present situation, the writer of the Rights, which are cash settlement put options, is also the issuer of the stock that is the subject of the Rights. Section 1032(a) of the Code provides specific rules governing the tax consequences to an issuer on the lapse or acquisition of an option to buy or sell its stock. Since cash settlement of an option is treated as a sale or exchange of the option, transfer of Payment upon maturity of the Rights is treated as an acquisition of a put option with respect to the issuer's stock. Therefore, pursuant to section 1032(a), *X* recognizes no gain or loss on repurchase of the Rights (including transfer of Payment) or on their lapse (for example, a payment of $0.10). *X* also does not recognize a gain if it makes the Payments by issuing its own stock to a holder. *See* Rev. Rul. 62-617, 1962-2 C.B. 59.

Because, as discussed above, *X* recognizes no gain or loss on the repurchase of the Rights, or on Payment, *X* also recognizes no gain or loss on the issuance of the Rights, and *X* does not have to establish a deferred account for the proceeds from the issuance of the Rights.

HOLDINGS

1. A Unit issued by *X* is comprised of two separate items of property, a share of *X* common stock and a Right. A purchaser of a Unit has a basis in the common stock of $8 and a basis in the Right of $2. For federal income tax purposes, a Right is a cash settlement put option.

2. Because a Right substantially diminishes a stockholder's risk of loss from a decline in value of the *X* common stock and a Right constitutes an option within the meaning of section 1092(d)(3)(B)(i)(I) of the Code, a Unit is a straddle as defined in section 1092(c)(1). A taxpayer is a holder of a straddle during the period the taxpayer holds both a Right and a share of *X* common stock, regardless whether they were acquired as a Unit or separately.

The characterization of any gain or loss as short or long term and the timing of the recognition of any loss is governed by section 1092(a) of the Code and the temporary regulations under section 1092(b) in the following situations: The taxpayer is a holder of a straddle consisting of a Right and a share of *X* common stock and (a) the taxpayer sells the Right or the share of *X* common stock prior to the Payment Date, (b) the Right lapses (that is, there is a Payment of $0.10), or (c) the taxpayer receives a Payment of more than $0.10 on the Payment Date.

If the taxpayer acquires only a Right and then either sells the Right or receives a Payment on the Payment Date, section 1092 of the Code and the regulations thereunder do not apply. Accordingly, any gain or loss recognized by the taxpayer on the sale of the Right or on the lapse of or on the exercise of the Right is a short- or long-term capital gain or loss, depending on the holding period for the Right.

3. *X* recognizes no gain or loss on the issuance of the Units, on repurchase of the Rights (including transfer of Payment), or on lapse of the Rights.

Section 1234A.—Gains or Losses from Certain Terminations

If a holder of a corporation's contingent payment right that for federal income tax purposes is a cash settlement put option receives a minimum payment of a *de minimis* amount upon termination of the right, the right is treated as lapsing and the characterization of the loss as short or long term and the timing of the recognition of the loss is the same as in the case of a sale of the right. See Rev. Rul. 88-31, page 302.

Section 1253.—Transfers of Franchises, Trademarks, and Trade Names

Franchises; amortization deductions. If a franchise is transferred by a franchisee, then the transferee of the franchise may amortize the acquisition cost allocable to the franchise rights under section 1253(d)(2) of the Code.

Rev. Rul. 88-24

ISSUE

If a taxpayer purchases all of the assets of a franchisee's business, including the franchise rights, for a fixed sum and the original franchisor retains a significant power, right, or continuing interest with respect to the franchise, is the taxpayer entitled, pursuant to section 1253(d)(2) of the Internal Revenue Code, to amortize the portion of the purchase price allocable to the franchise?

FACTS

In 1967, *Z* transferred a franchise to *Y*. The franchise agreement gave *Y* the exclusive right to package, distribute, and sell products bearing the *Z* trade names and trademarks within a certain geographic area. Pursuant to the franchise agreement, *Y* was required to follow specific formulas in the production process, to maintain adequate productive capacity, to meet various quality control standards, and to promote the sale and distribution of the *Z* products. The agreement stated that *Y*'s rights under the franchise agreement could not be transferred without the prior written consent of *Z*. The agreement contained no restrictions on the duration of the franchise granted to *Y*, provided *Y* complies with the provisions of the agreement. The agreement is a "franchise" as defined in section 1253(b)(1) of the Code. The franchise is also a "capital asset" in *Y*'s hands, within the meaning of section 1221 of the Code.

In 1987, *Y* sold its business to *X* for 200,000*x* dollars. Among the assets transferred to *X* were *Y*'s rights under the franchise agreement with *Z*. *X* can establish under section 1060 of the Code that 10,000*x* dollars of the total 200,000*x* purchase price was paid for the franchise rights, that 100,000x dollars was paid for the tangible assets, and that the remaining 90,000x dollars represented the going concern value and goodwill of the business. *X*, *Y*, and *Z* are unrelated parties. Prior to the sale, *Z* consented to the transfer of the franchise rights to *X* and confirmed that the franchise agreement remained in full force and effect after the sale. Although *Y* did not retain any interest in the franchise, *X* is subject to the same restrictions and conditions imposed by *Z* in the franchise agreement issued to *Y*. *X* did not pay any amount to *Z* on the transfer of the franchise.

On its federal income tax return for the 1987 calendar year, *X* claimed a deduction of 1,000*x* dollars (1/10 of the 10,000*x* dollars paid to *Y* for the franchise rights) under section 1253(d)(2)(A) of the Code.

LAW AND ANALYSIS

Section 1253(a) of the Code states that a transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.

Section 1253(b)(1) of the Code states that the term "franchise" includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specific area.

Section 1253(b)(2) of the Code states that the term "significant power, right, or continuing interest" includes, but is not limited to, the following rights with respect to the interest transferred:

(A) A right to disapprove any assignment of such interest, or part thereof.

(B) A right to terminate at will.

(C) A right to prescribe the standards of quality of products used or sold, or of services furnished, and of the equipment and facilities used to promote such products or services.

(D) A right to require that the transferee sell or advertise products or services of the transferor.

(E) A right to require that the transferee purchase substantially all supplies and equipment from the transferor.

(F) A right to payments contingent on the productivity, use, or disposition of the subject matter of the interest transferred if such payments constitute a substantial element under the transfer agreement.

Section 1253(d)(2)(A) of the Code states that if a transfer of a franchise, trademark, or trade name is not (by reason of the application of subsection (a)) treated as a sale or exchange of a capital asset, then any noncontingent payment which is made in discharge of a principal sum agreed upon in the transfer agreement shall be allowed as a deduction (in the case of a single payment made in discharge of such principal sum) ratably over the period beginning with the tax year in which the payment is made and ending with the ninth succeeding tax year or ending with the last tax year beginning in the period of the transfer agreement, whichever period is shorter.

In the present situation, *Y* did not retain any significant power, right, or continuing interest with respect to the transferred franchise. The franchise was a capital asset in *Y*'s hands. As to *Y*, therefore, the transaction was a sale of a capital asset.

X, however, acquired the franchise subject to the rights and powers imposed by *Z* in the original franchise agreement between *Z* and *Y*. These retained rights and powers constitute significant powers, rights, and continuing interests under section 1253(b)(2) of the Code. If *X* had acquired the franchise directly from *Z*, *X* would have been entitled under section 1253(d)(2) to amortize the cost of the franchise over a period of 10 years. The question presented, therefore, is whether *X* is to be denied the benefits of amortization because the franchise was acquired from the prior franchisee rather than from the franchisor.

Section 1253 of the Code does not address specifically the problem of a transfer of a franchise from a prior franchisee to a subsequent franchisee. It can be argued, however, that a literal reading of the statute precludes the subsequent franchisee from obtaining the benefits of amortization under section 1253(d)(2), which applies only if section 1253(a) causes the transfer to be treated other than as a sale or exchange of a capital asset. When, as in the present situation, the prior franchisee retains no significant power, right, or continuing interest, the transaction can be viewed as such a sale or exchange.

Although the above argument is consistent with the express language of the statute, it ignores the congressional intent that a taxpayer should be entitled to amortize its cost under section 1253(d)(2) of the Code if it obtains a franchise subject to a significant power, right, or continuing interest. The tax treatment afforded the purchaser should not turn upon whether the franchise was obtained from the franchisor or from a prior franchisee.

In addition, although the consideration for the franchise in the present case was paid to the prior franchisee, the franchisor was a party to the transaction because the franchisor's consent was required to effect the transfer. The franchise rights run from the franchisor to the new franchisee, and the franchisor retains a significant power, right, or continuing interest. Thus, from the standpoint of the new franchisee, both the prior franchisee and the franchisor are transferors and the transfer is subject to the type of restrictions that, under section 1253(a) of the Code, normally prevent the transaction from being considered a sale or exchange of a capital asset.

HOLDING

X is entitled, under section 1253(d)(2) of the Code, to amortize the portion of the purchase price attributable to its acquisition of *Y*'s franchise rights.

This holding is limited to amounts properly allocable to the franchise rights acquired. The Internal Revenue Service will scrutinize closely transactions of this type to ensure a proper allocation of the purchase price among the franchise, goodwill, and other assets.

Part V.—Special Rules for Bonds and Other Debt Instruments
Subpart A.—Original Issue Discount

Section 1273.—Determination of Amount of Original Issue Discount

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1988. See Rev. Rul. 88-1, this page.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 280G, 382, 383, 467, 468, 483, 1273, 1288.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for January 1988.

Rev. Rul. 88-1

For purposes of section 1274(d) of the Internal Revenue Code, the short-term, mid-term, and long-term applicable federal rates (AFR) for the month of January 1988 are as follows:

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	7.56%	7.42%	7.35%	7.31%
110% AFR	8.33%	8.16%	8.08%	8.02%
120% AFR	9.10%	8.90%	8.80%	8.74%
Mid-Term				
AFR	8.81%	8.62%	8.53%	8.47%
110% AFR	9.70%	9.48%	9.37%	9.30%
120% AFR	10.61%	10.34%	10.21%	10.12%
Long-Term				
AFR	9.27%	9.06%	8.96%	8.89%
110% AFR	10.22%	9.97%	9.85%	9.77%
120% AFR	11.17%	10.87%	10.73%	10.63%

For purposes of section 1288 of the Code, the short-term, mid-term, and long-term adjusted federal rates (adjusted AFR) for the month of January 1988 are as follows:

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term				
AFR	5.75%	5.67%	5.63%	5.60%
Mid-term				
AFR	6.38%	6.28%	6.23%	6.20%
Long-term				
AFR	7.54%	7.40%	7.33%	7.29%

For purposes of section 382 of the Code, the adjusted federal long-term rate and the long-term tax-exempt rate for January 1988 are as follows:

Adjusted federal long-term rate for January	7.54%
Long-term tax-exempt rate for ownership changes during January (the highest of the adjusted federal long-term rates for the current month and the prior two months)	8.04%

(Also Sections 42, 180G, 382, 467, 468, 483, 1288, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for February 1988.

Rev. Rul. 88-9

This revenue ruling provides various prescribed rates for federal income tax purposes for February 1988 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Finally, Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month.

REV. RUL. 88-9 TABLE 1
Applicable Federal Rates (AFR) for February 1988

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	7.61%	7.47%	7.40%	7.36%
110% AFR	8.39%	8.22%	8.14%	8.08%
120% AFR	9.16%	8.96%	8.86%	8.80%
Mid-Term				
AFR	8.73%	8.55%	8.46%	8.40%
110% AFR	9.63%	9.41%	9.30%	9.23%
120% AFR	10.52%	10.26%	10.13%	10.05%
Long-Term				
AFR	9.17%	8.97%	8.87%	8.81%
110% AFR	10.11%	9.87%	9.75%	9.67%
120% AFR	11.05%	10.76%	10.62%	10.53%

REV. RUL. 88-9 TABLE 2
Adjusted AFR for February 1988

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	5.47%	5.40%	5.36%	5.34%
Mid-term adjusted AFR	6.20%	6.11%	6.06%	6.03%
Long-term adjusted AFR	7.47%	7.34%	7.27%	7.23%

REV. RUL. 88-9 TABLE 3
Rates Under Section 382 for February 1988

Adjusted federal long-term rate for the current month	7.47%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months).	8.04%

REV. RUL. 88-9 TABLE 4
Appropriate Percentages Under Section 42(b)(2) for February 1988

70% present value low-income housing credit	9.12%
30% present value low-income housing credit	3.91%

(Also Sections 42, 280G, 382, 467, 468, 483, 1288, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for March 1988.

Rev. Rul. 88-15

This revenue ruling provides various prescribed rates for federal income tax purposes for March 1988 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Finally, Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month.

REV. RUL. 88–15 TABLE 1

Applicable Federal Rates (AFR) for March 1988

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	7.14%	7.02%	6.96%	6.92%
110% AFR	7.87%	7.72%	7.65%	7.60%
120% AFR	8.60%	8.42%	8.33%	8.28%
Mid-Term				
AFR	8.15%	7.99%	7.91%	7.86%
110% AFR	8.98%	8.79%	8.70%	8.63%
120% AFR	9.82%	9.59%	9.48%	9.40%
Long-Term				
AFR	8.63%	8.45%	8.36%	8.30%
110% AFR	9.52%	9.30%	9.19%	9.12%
120% AFR	10.40%	10.14%	10.01%	9.93%

REV. RUL. 88–15 TABLE 2

Adjusted AFR for March 1988

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	5.08%	5.01%	4.99%	4.97%
Mid-term adjusted AFR	5.79%	5.71%	5.67%	5.64%
Long-term adjusted AFR	7.07%	6.95%	6.89%	6.85%

REV. RUL. 88–15 TABLE 3

Rates Under Section 382 for March 1988

Adjusted federal long-term rate for the current month	7.07%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months).	7.54%

REV. RUL. 88–15 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for March 1988

Appropriate percentage for the 70% present value low-income housing credit	8.99%
Appropriate percentage for the 30% present value low-income housing credit	3.85%

(Also Sections 42, 280G, 382, 467, 468, 483, 1288, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for April 1988.

Rev. Rul. 88-22

This revenue ruling provides various prescribed rates for federal income tax purposes for April 1988 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Finally, Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month.

REV. RUL. 88-22 TABLE 1

Applicable Federal Rates (AFR) for April 1988

		Period for Compounding		
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	7.01%	6.89%	6.83%	6.79%
110% AFR	7.72%	7.58%	7.51%	7.46%
120% AFR	8.44%	8.27%	8.19%	8.13%
Mid-Term				
AFR	8.02%	7.87%	7.79%	7.74%
110% AFR	8.85%	8.66%	8.57%	8.51%
120% AFR	9.66%	9.44%	9.33%	9.26%
Long-Term				
AFR	8.57%	8.39%	8.30%	8.25%
110% AFR	9.44%	9.23%	9.13%	9.06%
120% AFR	10.32%	10.07%	9.95%	9.87%

REV. RUL. 88-22 TABLE 2

Adjusted AFR for April 1988

		Period for Compounding		
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	4.83%	4.77%	4.74%	4.72%
Mid-term adjusted AFR	5.79%	5.71%	5.67%	5.64%
Long-term adjusted AFR	7.12%	7.00%	6.94%	6.90%

REV. RUL. 88-22 TABLE 3

Rates Under Section 382 for April 1988

Adjusted federal long-term rate for the current month	7.12%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months).	7.47%

REV. RUL. 88-22 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for April 1988

Appropriate percentage for the 70% present value low-income housing credit	8.96%
Appropriate percentage for the 30% present value low-income housing credit	3.84%

(Also Sections 42, 280G, 382, 467, 468, 483, 1288, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for May 1988.

Rev. Rul. 88-28

This revenue ruling provides various prescribed rates for federal income tax purposes for May 1988 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Finally, Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month.

REV. RUL. 88-28 TABLE 1
Applicable Federal Rates (AFR) for May 1988

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	7.22%	7.09%	7.03%	6.99%
110% AFR	7.95%	7.80%	7.73%	7.68%
120% AFR	8.69%	8.51%	8.42%	8.36%
Mid-Term				
AFR	8.34%	8.17%	8.09%	8.03%
110% AFR	9.19%	8.99%	8.89%	8.83%
120% AFR	10.04%	9.80%	9.68%	9.61%
Long-Term				
AFR	8.86%	8.67%	8.58%	8.52%
110% AFR	9.77%	9.54%	9.43%	9.36%
120% AFR	10.67%	10.40%	10.27%	10.18%

REV. RUL. 88-28 TABLE 2
Adjusted AFR for May 1988

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	5.15%	5.09%	5.06%	5.04%
Mid-term adjusted AFR	6.01%	5.92%	5.88%	5.85%
Long-term adjusted AFR	7.44%	7.31%	7.24%	7.20%

REV. RUL. 88-28 TABLE 3
Rates Under Section 382 for May 1988

Adjusted federal long-term rate for the current month	7.44%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months).	7.44%

REV. RUL. 88-28 TABLE 4
Appropriate Percentages Under Section 42(b)(2) for May 1988

Appropriate percentage for the 70% present value low-income housing credit	9.04%
Appropriate percentage for the 30% present value low-income housing credit	3.87%

Section 1274

(Also Sections 42, 280G, 382, 467, 468, 483, 1288, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for June 1988.

Rev. Rul. 88-44

This revenue ruling provides various prescribed rates for federal income tax purposes for June 1988 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Finally, Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month.

REV. RUL. 88-44 TABLE 1
Applicable Federal Rates (AFR) for June 1988

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	7.57%	7.43%	7.36%	7.32%
110% AFR	8.34%	8.17%	8.09%	8.03%
120% AFR	9.12%	8.92%	8.82%	8.76%
Mid-Term				
AFR	8.69%	8.51%	8.42%	8.36%
110% AFR	9.58%	9.36%	9.25%	9.18%
120% AFR	10.47%	10.21%	10.08%	10.00%
Long-Term				
AFR	9.22%	9.02%	8.92%	8.86%
110% AFR	10.17%	9.92%	9.80%	9.72%
120% AFR	11.11%	10.82%	10.68%	10.58%

REV. RUL. 88-44 TABLE 2
Adjusted AFR for June 1988

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	5.01%	4.95%	4.92%	4.90%
Mid-term adjusted AFR	6.08%	5.99%	5.95%	5.92%
Long-term adjusted AFR	7.44%	7.31%	7.24%	7.20%

REV. RUL. 88-44 TABLE 3

Rates Under Section 382 for June 1988

Adjusted federal long-term rate for the current month	7.44%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months).	7.44%

REV. RUL. 88-44 TABLE 4

Appropriate Percentages Under Section 42(b)(2)
for June 1988

Appropriate percentage for the 70% present value low-income housing credit	9.13%
Appropriate percentage for the 30% present value low-income housing credit	3.91%

Subpart D.—Miscellaneous Provisions

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates for the month of January 1988. See Rev. Rul. 88-1, page 307.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1988. See Rev. Rul. 88-9, page 307.

The adjusted applicable federal short-term, mid-term, and long-term rates for the month of March 1988. See Rev. Rul. 88-15, page 308.

The adjusted applicable federal short-term, mid-term, and long-term rates for the month of April 1988. See Rev. Rul. 88-22, page 309.

The adjusted applicable federal short-term, mid-term, and long-term rates for the month of May 1988. See Rev. Rul. 88-28, page 310.

The adjusted applicable federal short-term, mid-term, and long-term rates for the month of June 1988. See Rev. Rul. 88-44, page 312.

Part VI.—Treatment of Certain Passive Foreign Investment Companies
Subpart A.—Interest on Tax Deferral

Section 1291.—Interest on Tax Deferral

26 CFR 1.1291: Passive foreign investment companies.

T.D. 8178

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER A, PART I—INCOME TAX; TAXABLE YEARS. BEGINNING AFTER DECEMBER 31, 1953; PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Elections under Sections 1291, 1294, 1295, and 1297

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary income tax regulations that provide guidance to passive foreign investment companies and their shareholders that are United States persons about the time, manner and other requirements for making certain elections. These elections were enacted by the Tax Reform Act of 1986. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking *** [page 916, this Bulletin].

DATE: Taxable years beginning after December 31, 1986.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains Temporary Income Tax Regulations (26 CFR Part 1) under sections 1291(d)(2), 1294, 1295, and 1297(b)(1) of the Internal Revenue Code of 1986. These provisions were added to the Internal Revenue Code of 1986 by section 1235 of the Tax Reform Act of 1986 (Pub. L. 99-514). The temporary regulations are effective for taxable years beginning after 1986. However, these regulations are not intended to address comprehensively the issues raised by sections 1291, 1294, 1295, and 1297 of the Code.

NEED FOR TEMPORARY GUIDANCE

The temporary regulations provided by this document will remain in effect until superseded by final regulations on these elections. Passive foreign investment companies and their shareholders wishing to make the elections in this Treasury decision for their first taxable year beginning after 1986 have an immediate need for guidance with respect to the time and manner of making the elections. For this reason, it is impracticable to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or to issue the decision subject to the effective date limitation of subsection (d) of that section.

EXPLANATION OF PROVISIONS

General

The Tax Reform Act of 1986 established special rules for the taxation of U.S. persons that are shareholders of passive foreign investment companies (PFICs). For taxable years beginning after December 31, 1986, a foreign corporation will be classified as a PFIC if either 75 percent or more of its gross income for the taxable year is passive, or 50 percent or more of the average value of its assets for the taxable year produce passive income or are held for the production of passive income. Subject to certain exceptions, passive income for these purposes generally is foreign personal holding company income as defined in section 954(c) of the Internal Revenue Code.

There are two types of PFICs. Absent an election to be treated as a qualified electing fund (QEF), a PFIC is considered a "nonqualified fund." U.S. persons that are shareholders of nonqualified funds are subject to special ordinary income treatment and a deferred tax amount upon disposition of the stock and receipt of certain distributions. If, however, a PFIC makes the election under section 1295 to be a QEF, its shareholders that are U.S. persons will be taxed currently on their respective shares of the QEF's earnings.

Statutory Provisions

Election to be a Qualified Electing Fund. A PFIC may make the election under section 1295 to be a QEF for any taxable year. To be effective for a particular taxable year, the election must be filed with the Internal Revenue Service Center in Philadelphia before the 15th day of the third month of the following taxable year. The election, once made, applies to the year for which first effective and all subsequent taxable years that the electing company is a PFIC. The election may be revoked only with the consent of the Secretary. In addition, to be a QEF, the PFIC must comply with requirements prescribed by the Secretary for determining its ordinary earnings and net capital gain for each taxable year, for reporting the U.S. ownership of its stock, and for other purposes necessary to carry out the objectives of the PFIC provisions.

QEF Shareholder Election to Recognize Gain. U.S. persons that are shareholders of a QEF are taxed under section 1293 on their pro rata shares of the QEF's annual ordinary earnings and net capital gain. If the QEF was a nonqualified fund in a prior taxable year included in the shareholder's holding period, the U.S. person also may be taxable under section 1291 on dispositions of the QEF stock and receipt of certain distributions. To limit the shareholders taxation to section 1293, the shareholder may make the election under section 1291(d)(2) to mark the stock to market as of the first day of the QEF's first taxable year as a QEF. A U.S. person making this election is deemed to have sold the stock held in the QEF on that day for its fair market value. The deemed sale is taxable as a disposition subject to the special tax rules of section 1291. Gain, but not loss, realized on the deemed sale will be recognized. The shareholder's basis in the stock will be adjusted for any gain recognized, and the shareholder's holding period shall thereafter be treated as beginning on the date of the deemed sale. Thereafter, the shareholder will be taxable only under section 1293 with respect to the subsequent earnings derived from the investment in the QEF.

Election to Extend Time for Payment of Tax. The U.S. investor in a QEF is currently taxed on the undistributed earnings of the QEF; however, section 1294 enables the shareholder to elect annually to defer payment of the tax on those earnings, subject to an interest charge. The electing shareholder may terminate the election at any time by paying the tax and interest due. Otherwise, the election automatically terminates upon the occurrence of an event described in section 1294(c).

Election to Purge Stock of PFIC Taint. If, in a particular taxable year, a shareholder owns stock in a foreign corporation which qualifies as a PFIC under section 1296, the stock will retain its character as PFIC stock in subsequent taxable years unless the PFIC is a QEF for the shareholder's entire holding period. An election is available under section 1297(b)(1), however, which allows a shareholder to purge the PFIC taint attributable to stock of a corporation that was a PFIC but no longer qualifies as such under the passive income or passive asset test of section 1296 (former PFIC). Unless the election is made, the shareholder will continue to be taxable pursuant to section 1291 even after the corporation ceases to meet the PFIC definitional test of section 1296. The election effects a deemed sale of the stock and only applies in circumstances in which the PFIC was not a qualified electing fund at some time during the electing shareholder's holding period. The electing shareholder is treated as having sold the stock in the former PFIC on the last day of the former PFIC's last taxable year during which it met the PFIC definitional test. The deemed sale is treated as a disposition for purposes of section 1291 and, therefore, is subject to the deferred tax amount defined in section 1291(c).

EXPLANATION OF TEMPORARY REGULATIONS

The temporary regulations provide the time, manner and other requirements for making the elections under section 1291(d)(2), 1294, 1295, and 1297(b)(1).

Election to be a Qualified Electing Fund. Section 1.1295-1T of the temporary regulations prescribes the time and manner for making the QEF election and the requirements for continued QEF qualification. The temporary regulations provide that the PFIC must file its QEF election with the Philadelphia Service Center before the 15th day of the third month following the taxable year for which the election is made. The temporary regulations permit a PFIC whose post-1986 short taxable year ended before December 31, 1987 to make the election any time before March 15, 1988. The QEF election will not be available to PFICs with any bearer shares. As part of the election, the PFIC must provide certain information, including the total ordinary earnings and net capital gain for the year of the election and, in certain cases, the fair market of a share of its stock as of the first day of the election year. However, any PFIC which must file its election statement before May 15, 1988, will be able to amend and supplement the information provided in its election statement as well as extend the time to satisfy the other election requirements in §1.1295-1T(b) described below by June 15, 1988.

The temporary regulations also require the PFIC to notify its shareholders of the daily amount of ordinary earnings and net capital gain of the PFIC deemed earned on a share of stock during the taxable year. However, if the number of outstanding shares of stock in the PFIC changed at any time during the year, the PFIC must provide the shareholders a schedule of the per share amounts of ordinary earnings and net capital gain of the PFIC for each day during the taxable year. The PFIC must send the shareholder notification and request for certification by the 15th day of the third month following each taxable year to which the election applies. However, the date for sending shareholder notification and request for certification statements is extended until June 15, 1988 for elections filed before March 15, 1988 under §1.1295-1T(b)(1)(iii) of the temporary regulations.

The shareholder notification and certification statement will require certain shareholders of record that hold the stock for their own benefit to complete the certification statement and return it to the PFIC. The shareholder notification and request for certification statement also will advise certain types of shareholders of record to notify their owners, or the persons on whose behalf they hold the stock, of their pro rata shares of the earnings of the PFIC. These shareholders also must be advised to request the indirect owners to report their status as U.S. persons to the PFIC. Only U.S. persons that are direct or indirect shareholders of the PFIC are required to certify their status to the PFIC. The temporary regulations provide that failure of a shareholder to comply with the request for certification will not invalidate the QEF election.

The temporary regulations require the QEF to provide the Internal Revenue Service, by the 15th day of the ninth month following each taxable year to which the election applies, the names, addresses and taxpayer identification numbers of the U.S. persons obtained through certification, and their pro rata shares of the ordinary earnings and net capital gain. For taxable years after the year of the election, this information will be required as part of the annual report to be filed by the QEF by the 15th day of the ninth month following each year to which the election applies. The annual report will be similar to the election statement.

The temporary regulations also require a QEF to amend the earnings information filed with the Internal

Revenue Service and sent to its shareholders at any time that a recalculation of the ordinary earnings and net capital gain of the QEF is necessary.

The temporary regulations under §1.1295-1T(b)(3) require the QEF to appoint a person resident in the United States as the QEF's authorized representative in the United States for tax administrative purposes. Section 1.1295-1T(b)(4) requires the QEF to maintain permanent books of account, records and other documents that are necessary to verify the reported amounts of ordinary income and capital gain, to maintain ledgers of all shareholders of record for each year to which the election applies, to keep copies of such documents in the United States, and to make the documents available for inspection by Internal Revenue Service personnel.

Section 1.1295-1T(b)(9) provides that if the electing corporation was a nonqualified fund during a post-1986 taxable year prior to the taxable year for which the section 1295 election is made, it must determine, for purposes of the shareholder election under section 1291(d)(2), the fair market value of its stock on the first day of its first taxable year as a QEF (the valuation date) according to the rules specified in §1.1295-1T(b)(9)(i) and (ii). This requirement does not apply to a foreign corporation that makes the election for its first taxable year during which it qualifies as a PFIC. A PFIC required to make the fair market value determination must provide this information to those persons that were its shareholders on the valuation date.

The section 1295 election may be revoked by the PFIC but only with the consent of the Commissioner. The Commissioner's determination will take into account the enactment of technical corrections to the Tax Reform Act of 1986 after the PFIC made the election, as well as provisions of PFIC regulations published after the PFIC made the election.

QEF Shareholder Election to Recognize Gain. Section 1.1291-10T specifies the time and manner for making the election under section 1291(d)(2) of the Code to treat the stock of a PFIC as sold on the first day on which the PFIC is a QEF. This election only applies to a U.S. person that held such stock in the QEF when it was a nonqualified fund. The election may be made by a shareholder that may realize either a gain or a loss on the deemed sale (although the loss will not be recognized). Section 1.1291-10T(c) provides that the shareholder may make the election only with respect to the taxable year that includes the first day of the QEF's first taxable year as a QEF. Section 1.1291-10T(d) provides that, in order to make the election under section 1291(d)(2), the shareholder generally must pay the tax arising under section 1291 by the due date (determined without extensions) of the return for the shareholder's taxable year that includes the first day of the QEF's first taxable year as a QEF. If the shareholder files the election after the due date, the electing shareholder will have to pay the tax on the gain included in income, the deferred tax amount, and the interest for the underpayment of tax pursuant to section 6601.

The temporary regulations provide rules for direct shareholders making the election under section 1291(d)(2). Guidance for indirect shareholders wishing to make the election will be provided at a later time.

Election to Extend Time for Payment of Tax. Section 1.1294-1T specifies the time and manner for making the annual election under section 1294 to extend the time for payment of the tax liability which is attributable to the undistributed earnings of the QEF, included in income under section 1293, for the taxable year of the QEF that ended during the taxable year of the shareholder. The tax liability is defined in §1.1294-1T(f) as the excess of the tax imposed under chapter 1 of the Code for the taxable year over the tax that would be imposed for the taxable year without regard to the inclusion in income under section 1293 of undistributed earnings. The electing shareholder will be required to state in the section 1294 election the amount of ordinary earnings and net capital gain of the QEF included in the income of the shareholder for the year and the amount of the tax liability, payment of which is being deferred by reason of the election under section 1294. An extension of time to pay tax terminates upon the occurrence of any of the events listed in §1.1294-1T(e). These events include receipt of earnings to which the election is attributable, transfer or pledge of the stock with respect to which the section 1294 election applies, a loan, pledge or guarantee by the QEF to the electing shareholder or to a person related to the shareholder, cessation of the QEF's status as a QEF or as a PFIC, or a determination by the District Director pursuant to section 1294(c)(3) that collection of the tax is in jeopardy.

Election to Purge Stock of PFIC Taint. Section 1.1297-3T provides the time and manner for making the election under section 1297(b)(1) of the Code to treat the PFIC stock as sold on the last day of the last taxable year during which it was a PFIC. Thereafter, the foreign corporation will not be treated as a PFIC in the hands of the shareholder. The shareholder makes the election by filing an amended tax return within three years after the due date, as extended, of the shareholder's tax return for the taxable year that includes the date of the deemed sale. The shareholder must describe in the election the manner in which the former PFIC lost the characteristics of a PFIC. The electing shareholder will be liable for interest for underpayment of tax for the year of the deemed sale.

The temporary regulations provide rules for direct shareholders making the election under section 1297(b)(1). Guidance for indirect shareholders wishing to make the election will be provided at a later time.

SPECIAL ANALYSES

It has been determined that this temporary regulation is not a major rule as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. A general notice of proposed rule is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

PAPERWORK REDUCTION ACT

The collection of information requirements contained in this regulation have been submitted to the Office of Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduc-

tion Act of 1980. These requirements have been approved by OMB under control number 1545-1028:

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

INCOME TAX REGULATIONS

Paragraph 1. The authority for 26 CFR Part 1 continues to read in part:

Authority: 26 U.S.C. 7805. *** Sections 1.1291-10T, 1.1294-1T, 1.1295-1T, and 1.1297-3T also issued, respectively, under the authority of 26 U.S.C. 1291(d)(2), 1294, 1295 and 1297(b)(1).

Par. 2. New §§1.1291-0T, 1.1291-10T, 1.1294-1T, 1.1295-1T, and 1.1297-3T are added immediately following §1.1287-1.

The added sections read as follows:

§1.1291-0T. Passive Foreign Investment Companies. Table of contents (Temporary).

§1.1291-10T. Election by a United States person to recognize gain in a qualified electing fund
(a) Purpose and scope
(b) Election to recognize gain
(1) In general
(2) Qualification date
(3) Exception
(c) Time for making the election
(d) Manner of making the election
(1) In general
(2) Information to be included in the election
(e) Adjustment to basis; treatment of holding period

§1.1294-1T Election to extend the time for payment of tax on undistributed earnings of a qualified electing fund
(a) Purpose and scope
(b) Election to extend time for payment of tax
(1) In general
(2) Exception
(3) Undistributed earnings
(i) In general
(ii) Effect of loan, pledge or guarantee
(c) Time for making the election
(1) In general
(2) Exception
(d) Manner of making the election
(1) In general
(2) Information to be included in the election
(e) Termination of the extension
(f) Undistributed PFIC earnings tax liability
(g) Authority to require a bond
(h) Annual reporting requirement

§1.1295-1T Election by a passive foreign investment company to be a qualified electing fund
(a) In general
(b) Election requirements
(1) Time for making the election
(i) In general
(ii) Exception for elections for post-1986 years ended before 12/31/87
(iii) Curing an election made before 5/15/88
(2) Manner of making the election
(i) In general
(ii) Information to be included in the election statement
(3) Appointment of U.S. agent
(4) Books and records
(5) Annual shareholder notification and request for certification of U.S. ownership
(i) In general
(ii) The notification of PFIC information and request for shareholder certification
(6) Annual reporting by the PFIC to the Internal Revenue Service
(7) Amendment of earnings information
(8) Taxpayer identification number
(9) Fair market value determination by certain companies
(i) Companies other than open-end investment companies
(ii) Open-end investment companies
(c) Revocability of election
(1) In general
(2) Failure to obtain shareholder certification

§1.1297-3T Deemed sale election by a United States person that is a shareholder of a passive foreign investment company
(a) In general
(b) Time and manner for making the election
(1) In general
(2) Information to be included in the election
(3) Adjustment to basis; treatment of holding period

§1.1291-10T. Election by a United State person to recognize gain in a qualified electing fund (Temporary).

(a) *Purpose and scope*. This section provides rules for making the election under section 1291(d)(2). Under that section, a U.S. person may elect to recognize gain with respect to stock in a qualified electing fund (QEF) held on the first day of the QEF's first taxable year during which it is a QEF. In general, a QEF is a foreign corporation that is a passive foreign investment company (PFIC), as defined in section 1296, and that has made the election under section 1295. For rules concerning the election by a PFIC under section 1295, see §1.1295-1T.

(b) *Election to recognize gain*— (1) *In general.* A U.S. person may elect to recognize gain under the provisions of this §1.1291-10T if such person was a shareholder of a QEF on the qualification date. A person that makes such an election shall be treated as having sold on the qualification date for its fair market value stock of the QEF that the person held on that date. The deemed sale is taxed as a disposition pursuant to section 1291. Under that section, the gain is considered earned pro rata over the shareholder's holding period in the stock, and is taxed as ordinary income. The tax on the gain attributable to post-1986 taxable years during which the corporation is a PFIC is based on the value of tax deferral and includes an interest charge. An election may be made by a shareholder that would realize a loss on the deemed sale. Any loss realized on the deemed sale may not be recognized.

(2) *Qualification date*. The qualification date with respect to any shareholder of a QEF is the first day of the QEF's first taxable year as a QEF.

(3) *Exception*. This election does not pertain to a shareholder that held stock in a PFIC which was a QEF for all of the PFIC's taxable years beginning after 1986 during which it qualified as a PFIC and that are included in whole or in part in the sharehold-

er's holding period. See section 1291(d)(1).

(c) *Time for making the election.* Except as provided below, an election under this §1.1291-10T must be made with the filing of the electing shareholder's tax return for the taxable year which includes the qualification date. The election may be made by filing an amended tax return within three years of the due date, as extended, for the shareholder's tax return for the taxable year which includes the qualification date.

(d) Manner of making the election—(1) *In general.* The election shall be made by filing Form 8621 or a statement containing the information and representations required by paragraph (d)(2) of this section, reporting the gain on the income tax return as required by section 1291(a)(2), and by paying the tax on the gain as required by section 1291 (including the payment of the deferred tax amount required under sections 1291(a)(1)(C) and 1291(c)). The electing shareholder that makes the election under this section after the due date of the return (determined without extensions) shall pay interest, pursuant to section 6601, on the underpayment of tax for the taxable year that includes the qualification date.

(2) *Information to be included in the election.* If a statement is used in lieu of Form 8621, the statement should be identified, in a heading, as an election under section 1291(d)(2). The statement must contain the following information and representations:

(i) The name, address and taxpayer identification number of the electing shareholder;

(ii) The name, address and taxpayer identification number of the QEF, the stock of which is the subject of the election;

(iii) A statement that the shareholder is making the election under section 1291(d)(2);

(iv) A representation that the person making the election was a shareholder in the QEF on the qualification date;

(v) The qualification date;

(vi) A schedule of the shares held by the electing shareholder in the QEF on the qualification date, listing the date(s) of acquisition, the number of shares acquired on each date listed, and the electing shareholder's tax basis in each of those shares;

(vii) The fair market value of the stock in the QEF as of the qualification date, as provided to the electing shareholder by the QEF pursuant to §1.1295-1T(b)(5); and

(viii) A schedule showing the computation of the gain recognized on the deemed sale, and the calculation of the deferred tax amount, as defined in section 1291(c).

(e) *Adjustment to basis; treatment of holding period.* An electing shareholder that recognizes gain on the deemed sale shall increase its adjusted basis in the stock by the amount of gain recognized. An electing shareholder shall not adjust the basis in stock with respect to which the shareholder realized a loss on the deemed sale. An electing shareholder thereafter shall treat its holding period in the stock, for purposes of sections 1291 through 1297, as beginning on the qualification date without regard to whether it recognized gain on the deemed sale; for purposes of section 1223, the holding period in the stock in the QEF shall include the period prior to the deemed sale.

§1.1294-1T. Election to extend the time for payment of tax on undistributed earnings of a qualified electing fund (Temporary).

(a) *Purpose and scope.* This section provides rules for making the annual election under section 1294. Under that section, a U.S. person that is a shareholder in a qualified electing fund (QEF) may elect to extend the time for payment of its tax liability which is attributable to its share of the undistributed earnings of the QEF. In general, a QEF is a passive foreign investment company (PFIC), as defined in section 1296, that makes the election under section 1295. Under section 1293, a U.S. person that owns, or is treated as owning, stock of a QEF at any time during the taxable year of the QEF shall include in gross income, as ordinary income, its pro rata share of the ordinary earnings of the QEF for the taxable year and, as long-term capital gain, its pro rata share of the net capital gain of the QEF for the taxable year. The shareholder's share of the earnings shall be included in the shareholder's taxable year in which or with which the taxable year of the QEF ends.

(b) *Election to extend time for payment*—(1) *In general.* A U.S. person that is a shareholder of a QEF on the last day of the QEF's taxable year may elect under section 1294 to extend the time for payment of that portion of its tax liability which is attributable to the inclusion in income pursuant to section 1293 of the shareholder's share of the QEF's undistributed earnings. The election under section 1294 may be made only with respect to undistributed earnings, and interest is imposed under section 6601 on the amount of the tax liability which is subject to the extension. This interest must be paid on the termination of the election.

(2) *Exception.* An election under this §1.1294-1T cannot be made for a taxable year of the shareholder if any portion of the QEF's earnings is includible in the gross income of the shareholder for such year under either section 551 (relating to foreign personal holding companies) or section 951 (relating to controlled foreign corporations).

(3) *Undistributed earnings*—(i) *In general.* For purposes of this §1.1294-1T the term "undistributed earnings" means the excess, if any, of the amount includible in gross income by reason of section 1293(a) for the shareholder's taxable year (the includible amount) over the sum of (A) the amount of any distribution to the shareholder during the QEF's taxable year and (B) the portion of the includible amount that is attributable to stock in the QEF that the shareholder transferred or otherwise disposed of before the end of the QEF's year. For purposes of this paragraph, a distribution will be treated as made from the most recently accumulated earnings and profits.

(ii) *Effect of a loan, pledge or guarantee.* A loan, pledge, or guarantee described in §1.1294-1T(e)(2) or (4) will be treated as a distribution of earnings for purposes of paragraph (b)(3)(i)(A). If earnings are treated as distributed in a taxable year by reason of a loan, pledge or guarantee described in §1.1294-1T(e)(2) or (4), but the amount of the deemed distribution resulting therefrom was less than the amount of the actual loan by the QEF (or the amount of the loan secured by the pledge or guarantee), earnings derived by the QEF in a subsequent taxable year will be treated as distributed in such subsequent year to the shareholder for purposes of paragraph (b)(3)(i)(A) by virtue of such loan, but only to the extent of the difference between the outstanding principal balance on the loan in such subsequent year and the prior years' deemed distributions resulting from the loan. For this purpose, the outstanding principal balance on a loan in a taxable year shall be treated as equal to the greatest amount of the outstanding balance at any time during such year.

Example (1). (i) *Facts. FC* is a PFIC that made the election under section 1295 to be a QEF for its taxable year beginning January 1, 1987. *S* owned 500 shares, or 50 percent, of *FC* throughout the first six months of 1987, but on June 30, 1987 sold 10 percent, or 50 shares, of the *FC* stock that it held. *FC* had $100,000*x* of ordinary earnings but no net capital gain in 1987. No part of *FC*'s earnings is includible in *S*'s income under either section 551 or 951. *FC* made no distributions to its shareholders in 1987. *S*'s pro rata share of income is determined by attributing *FC*'s income ratably to each day in *FC*'s year. Accordingly, *FC*'s daily earnings are $274*x* ($100,000*x*/365). *S*'s share of the earnings of *FC* is $47,484*x*, determined as follows.

FC's daily earnings	X	number of days percentage held by *S*	X	percentage of ownership in *FC*.

Accordingly, *S*'s pro rata share of *FC*'s earnings for the first six months of *FC*'s year deemed earned while *S* held 50 percent of *FC*'s stock is $24,797*x* ($274*x* × 181 days × 50%). *S*'s pro rata share of *FC*'s earnings for the remainder of *FC*'s year deemed earned while *S* held 45 percent of *FC*'s stock is $22,687*x* ($274*x* × 184 days × 45%). Therefore, *S*'s total share of *FC*'s earnings to be included in income under section 1293 is $47,484*x* ($24,797*x* + $22,687*x*).

(ii) *Election. S* intends to make the election under section 1294 to defer the payment of its tax liability that is attributable to the undistributed earnings of *FC*. The amount of current year undistributed earnings as defined in §1.1294-1T(b)(3) with respect to which *S* can make the election is the excess of *S*'s inclusion in gross income under section 1293(a) for the taxable year over the sum of (1) the cash and other property distributed to *S* during *FC*'s tax year out of earnings included in income pursuant to section 1293(a), and (2) the earnings attributable to stock disposed of during *FC*'s tax year. Because *S* sold 10 percent, or 50 shares, of the *FC* stock that it held during the first six months of the year, 10 percent of its share of the earnings for that part of the year, which is $2,480*x* ($24,797*x* × 10%), is attributable to the shares sold. *S* therefore cannot make the election under section 1294 to extend the time for payment for its tax liability on that amount. Accordingly, *S* can make the election under section 1294 with respect to its tax on $45,004*x* ($47,484*x* less $2,480*x*), which is its pro rata share of *FC*'s earnings, reduced by the earnings attributable to the stock disposed of during the year.

Example (2). (i) *Facts.* The facts are the same as in Example (1) with the following exceptions. *S* did not sell any *FC* stock during 1987. Therefore, because *S* held 50 percent of the *FC* stock throughout 1987, *S*'s pro rata share of *FC*'s ordinary earnings was $50,000*x*, no part of which was includible in *S*'s income under either section 551 or 951. There were no actual distributions of earnings to *S* in 1988. On December 31, 1987, *S* pledged the FC stock as security for a bank loan of $75,000*x*. The pledge is treated as a disposition of the *FC* stock and therefore a distribution of *S*'s share of the undistributed earnings of *FC* up to the amount of the loan principal. *S*'s entire share of the undistributed earnings of *FC* are deemed distributed as a result of the pledge of the *FC* stock. *S* therefore cannot make the election under section 1294 to extend the time for payment of its tax liability on its share of *FC*'s earnings for 1987.

(ii) *Deemed distribution.* In 1988, *FC* has ordinary earnings of $100,000*x* but no net capital gain. *S*'s pro rata share of *FC*'s 1988 ordinary earnings was $50,000*x*. *S*'s loan remained outstanding throughout 1988; the highest loan balance during 1988 was $74,000*x*. Of *S*'s share of the ordinary earnings of *FC* of $50,000*x*, $24,000*x* is deemed distributed to *S*. This is the amount by which the highest loan balance for the year ($74,000*x* exceeds the portion of the undistributed earnings of *FC* deemed distributed to *S* in 1987 by reason of the pledge ($50,000*x*). *S* may make the election under section 1294 to extend the time for payment of its tax liability on $26,000*x*, which is the amount by which *S*'s includible amount for 1988 exceeds the amount deemed distributed to *S* during 1988.

(c) *Time for making the election*—(1) *In general.* An election under this §1.1294-1T may be made for any taxable year in which a shareholder reports income pursuant to section 1293. Except as provided in paragraph (c)(2), the election shall be made by the due date, as extended, of the tax return for the shareholder's taxable year for which the election is made.

(2) *Exeption.* An election under this section may be made within 60 days of receipt of notification from the QEF of the shareholder's pro rata share of the ordinary earnings and net capital gain if notification is received after the time for filing the election provided in paragraph (c)(1) (and requires the filing of an amended return to report income pursuant to section 1293). If the notification reports an increase in the shareholder's pro rata share of the earnings previously reported to the shareholder by the QEF, the shareholder may make the election under this paragraph (c)(2) only with respect to the amount of such increase.

(d) *Manner of making the election*—(1) *In general.* A shareholder shall make the election by (i) attaching to its return for the year of the election Form 8621 or a statement containing the information and representations required by this section and (ii) filing a copy of Form 8621 or the statement with the Internal Revenue Service Center, P.O. Box 21086, Philadelphia, Pennsylvania 19114.

(2) *Information to be included in the election statement.* If a statement is used in lieu of Form 8621, the statement should be identified, in a heading, as an election under section 1294 of the Code. The statement must include the following information and representations:

(i) The name, address, and taxpayer identification number of the electing shareholder and the taxable year of the shareholder for which the election is being made;

(ii) The name, address and taxpayer identification number of the QEF if provided to the shareholder;

(iii) A statement that the shareholder is making the election under section 1294 of the Code;

(iv) A schedule containing the following information:

(A) the ordinary earnings and net capital gain for the current year included in the shareholder's income under section 1293;

(B) the amount of cash and other property distributed by the QEF during its taxable year with respect to stock held directly or indirectly by the shareholder during that year, identifying the amount of such distributions that is paid out of current earnings and profits and the amount paid out of each prior year's earnings and profits; and

(C) the undistributed PFIC earnings tax liability (as defined in paragraph (f) of this section) for the taxable year, payment of which is being deferred by reason of the election under section 1294;

(v) The number of shares of stock held in the QEF during the QEF's taxable year which gave rise to the section 1293 inclusion and the number of such shares transferred, deemed transferred or otherwise disposed of by the electing shareholder before the end of the QEF's taxable year, and the date of transfer; and

(vi) The representations of the electing shareholder that—

(A) No part of the QEF's earnings for the taxable year is includible in the electing shareholder's gross income under either section 551 or 951 of the Code;

(B) The election is made only with respect to the shareholder's pro rata share of the undistributed earnings of the QEF; and

(C) The electing shareholder, upon termination of the election to extend the date for payment, shall pay the undistributed PFIC earnings tax liability attributable to those earnings to which the termination applies as well as interest on such tax liability pursuant to section 6601. Payment of this tax and interest must be made by the due date (determined without extensions) of the tax return for the taxable year in which the termination occurs.

(e) *Termination of the extension.* The election to extend the date for payment of tax will be terminated in whole or in part upon the occurrence of any of the following events:

(1) The QEF's distribution of earnings to which the section 1294 extension to pay tax is attributable; the extension will terminate only with respect to the tax attributable to the earnings that were distributed.

(2) The electing shareholder's transfer of stock in the QEF (or use thereof as security for a loan) with respect to which an election under this §1.1294-1T was made. The election will be terminated with respect to the undistributed earnings attributable to the shares of the stock transferred. In the case of a pledge of the stock, the election will be terminated with respect to undistributed earnings equal to the amount of the loan for which the stock is pledged.

(3) Revocation of the QEF's election as a QEF or cessation of the QEF's status as a PFIC. A revocation of the QEF election or cessation of PFIC status will result in the complete termination of the extension.

(4) A loan of property by the QEF directly or indirectly to the electing shareholder or related person, or a pledge or guarantee by the QEF with respect to a loan made by another party to the electing shareholder or related person. The election will be terminated with respect to undistributed earnings in an amount equal to the amount of the loan, pledge, or guarantee.

(5) A determination by the District Director pursuant to section 1294(c)(3) that collection of the tax is in jeopardy. The amount of undistributed earnings with respect to which the extension is terminated under this paragraph (d)(5) will be left to the discretion of the District Director.

(f) *Undistributed PFIC earnings tax liability.* The electing shareholder's tax liability attributable to the ordinary earnings and net capital gain included in gross income under section 1293 shall be the excess of the tax imposed under chapter 1 of the Code for the taxable year over the tax that would be imposed for the taxable year without regard to the inclusion in income under section 1293 of the undistributed earnings as defined in paragraph (b)(3) of this section.

Example. The facts are the same as in §1.1294-1T(b)(3), *Example (1)*, with the following exceptions. *S*, a domestic corporation, did not dispose of any *FC* stock in 1987. Therefore, because *S* held 50 percent of the *FC* stock throughout 1987, *S*'s pro rata share of *FC*'s ordinary earnings was $50,000*x*. In addition to $50,000*x* of ordinary earnings from *FC*, *S* had $12,500*x* of domestic source income and $6,000*x* of expenses (other than interest expense) not definitely related to any gross income. These expenses are apportioned, pursuant to §1.861-8(c)(2), on a pro rata basis between the domestic and foreign source income—$1,200*x* of expenses, or one-fifth, to domestic source income, and $4,800*x* of expenses, or four-fifths, to the section 1293 inclusion. *FC* paid foreign taxes of $25,000*x* in 1987. Accordingly, *S* is entitled to claim as an indirect foreign tax credit pursuant to section 1293(f) a proportionate amount of the foreign taxes paid by *FC*, which is $12,500*x* ($25,000*x* × $50,000*x*/$100,000*x*). *S* is taxed in the U.S. at the rate of 34 percent. The amount of tax liability for which *S* may extend the time for payment is determined as follows:

1987 Tax Liability (with section 1293 inclusion)

Source	*U.S.*	*Foreign*
Income	12,500*x*	0
Section 1293	0	50,000*x*
Expenses	*– 1,200x*	*– 4,800x*
Taxable income	11,300*x*	45,200*x*
Total taxable income	56,500*x*	
U.S. income tax rate	*x34%*	
Pre-credit U.S. tax	19,210*x*	
Foreign tax credit	*12,500x*	
1987 Tax Liability	6,710*x*	

§1.1294-1T (f) *Example*

1987 Tax Liability (without section 1293 inclusion)

Source	*U.S.*	*Foreign*
Income	12,500*x*	0
Expenses	*– 6,000x*	
Taxable income	6,500*x*	
U.S. tax rate	*x34%*	
U.S. tax	2,210*x*	
Foreign tax credit	*0*	
Hypothetical 1987 Tax Liability	2,210*x*	

The amount of tax, payment of which *S* may defer pursuant to section 1294, is $4,500*x* ($6,710*x* less $2,210*x*).

(g) *Authority to require a bond.* Pursuant to the authority granted in section 6165 and in the manner provided therein, and subject to notification, the District Director may require the electing shareholder to furnish a bond to secure payment of the tax, the time for payment of which is extended under this section. If the electing shareholder does not furnish the bond within 60 days after receiving a request from the District Director, the election will be revoked.

(h) *Annual reporting requirement.* The electing shareholder must attach

Form 8621 or a statement to its income tax return for each year during which an election under this section is outstanding. The statement must contain the following information: (1) the total amount of undistributed earnings as of the end of the taxable year to which the outstanding elections apply; (2) the total amount of the undistributed PFIC earnings tax liability and accrued interest charge as of the end of the year; (3) the total amount of distributions received during the taxable year; and (4) a description of the occurrence of any other termination event described in paragraph (e) of this section that occurred during the taxable year. The electing shareholder also shall file by the due date, as extended, for its return a copy of Form 8621 or the statement with the Philadelphia Service Center, P.O. Box 21086, Philadelphia, Pennsylvania 19114.

§1.1295-1T. Election by a passive foreign investment company to be a qualified electing fund (Temporary).

(a) *In general.* This section provides rules under which a foreign a corporation that qualifies as a passive foreign investment company (PFIC), as defined in section 1296, may make the election under section 1295 to be a qualified electing fund (QEF). U.S. persons that are shareholders of a QEF are taxable annually, pursuant to section 1293, on their pro rata shares of the earnings and profits of the QEF unless the shareholder makes the election under section 1294 to extend the time for payment of tax on undistributed earnings. The election under section 1295 may not be made by a PFIC that issues any of its shares in bearer form or is otherwise unable to identify all of its shareholders of record. The election will be effective with respect to all direct and indirect shareholders of the PFIC. The election may be made for any taxable year of the corporation during which it is a PFIC

(b) *Election requirements.* An election under section 1295 shall be valid only if the PFIC complies with the following requirements.

(1) *Time for making the election*—(i) *In general.* A PFIC must make the election under this section before the fifteenth day of the third month following the taxable year for which it is being made. Pursuant to section 7502 and the regulations thereunder, an election or an amended election under this section that is postmarked by United States mail on or before the due date will be considered timely filed. An election mailed by air, postage prepaid and properly addressed to the Internal Revenue Service Center in Philadelphia, Pennsylvania, and bearing an originating official postmark of a foreign postal authority dated at least 10 calendar days before the due date, will be deemed timely filed.

(ii) *Exception for elections for post-1986 years ended before 12/31/87.* A PFIC whose first post-1986 taxable year ended before December 31, 1987 may file its election under this section any time before March 15, 1988.

(iii) *Curing an election made before 5/15/88.* A PFIC that must file its election under this section before May 15, 1988 has until June 15, 1988 to satisfy all other requirements of this paragraph (b), provided that the PFIC has filed a statement containing the information specified in paragraph (b)(2)(ii)(A), (B) and (C) of this section at the address specified in paragraph (b)(2)(i) before the fifteenth day of the third month following the taxable year for which the election is made (or, in the case of any PFIC described in paragraph (b)(1)(ii), before March 15, 1988).

(2) *Manner of making the election*—(i) *In general.* A PFIC shall make an election under this section by filing Form 8644 (if available) or a statement, in English, containing the information and representations required by this paragraph (b)(2). the form or statement shall be filed with the Internal Revenue Service Center, P.O. Box 21086, Philadelphia, Pennsylvania 19114 U.S.A. The form or statement shall be signed by a responsible officer of the PFIC who verifies, under penalties of perjury, that the officer is authorized to make the election on behalf of the PFIC and that all the information and representations provided in the form or statement are true, correct, and complete to the best of the officer's knowledge and belief.

(ii) *Information to be included in the election statement.* If a statement is used, the statement should be identified, in a heading, as an election under section 1295. The statement must contain the following information and representations:

(A) The name, address, taxpayer identification number, if any, and country and year of incorporation of the PFIC.

(B) A statement that the PFIC is making the election under section 1295 and the date on which the PFIC is making the election.

(C) The taxable year to which the election under section 1295 applies.

(D) The name and address of the United States resident who has been designated by the PFIC as its U.S. agent pursuant to paragraph (b)(3) of this section.

(E) The PFIC's representation that it will maintain its books of account, records, shareholder ledgers, and other documents in the United States in accordance with paragraph (b)(4) of this section and will make such documents available for inspection in the United States by personnel of the Internal Revenue Service.

(F) The name and address of the person (or persons) having custody of the PFIC's books of account, records, shareholder ledgers, and other documents in the United States.

(G) A description of each class of stock of the PFIC outstanding during the taxable year, and the manner in which the stock was traded; if the stock is traded in an established securities market(s), the name of the market(s).

(H) The total amount of ordinary earnings and net capital gain of the PFIC for the taxable year, as determined under United States federal income tax principles and in accordance with section 1293(e). The computations for this purpose shall be determined in the company's functional currency, as defined in section 985(b), and then translated into U.S. dollars, if necessary, at the weighted average exchange rate for the PFIC's taxable year, as provided in section 989(b), specifying the rate of exchange utilized.

(I) The amount of distributions of U.S. dollars and the fair market value and description of any other property (including foreign currency) distributed during the taxable year of the PFIC to which the election under this section applies.

(J) If the PFIC is required to make the fair market value determination under paragraph (b)(9) of this section, the fair market value of one share of each class of stock in the PFIC as of the first day of the PFIC's first taxable year as a QEF, specifying the manner in which the fair market value of the stock was determined, and the relevant data, including the sources thereof, used in the determination. The PFIC shall notify its shareholders of the value of its stock as provided in paragraph (b)(5) of this section.

(3) *Appointment of U.S. agent.* The PFIC shall appoint a person resident in the United States as its authorized representative in the United States (U.S. agent). The PFIC shall have a U.S. agent at all times after the election under section 1295 is made (or perfected pursuant to paragraph (b)(1)(iii) of this section) and during which it remains in effect. The U.S. agent shall be the PFIC's representative for all purposes relating to the administration and enforcement of the federal income tax laws, including providing the Commissioner or his delegate with such information and documents or access thereto as the Commissioner may require for the administration of sections 1291 through 1297 and the regulations thereunder.

(4) *Books and records.* The PFIC shall maintain for each taxable year to which the election under section 1295 applies permanent books of account, records and such other documents as are necessary to establish its ordinary earnings and net capital gain as provided in section 1293(e) and computed in accordance with U.S. generally accepted accounting principles and federal income tax principles. The PFIC also shall maintain for each taxable year to which the election under section 1295 applies a ledger of all shareholders of record during the taxable year. The PFIC shall keep copies of such books, records, shareholder ledgers and other documents in the United States and shall maintain them so long as the contents thereof may be material to the administration of sections 1291 through 1297, but for not less than 10 years. Such books, records, shareholder ledgers and other documents shall be available for inspection in the United States by authorized Internal Revenue officers or employees.

(5) *Annual shareholder notification and request for certification of U.S. ownership*—(i) *In general.* Before the fifteenth day of the third month following each taxable year for which the election is in effect, the PFIC shall send the notification of PFIC information and request for shareholder certification statements, set forth in paragraph (b)(5)(ii) of this section, to all persons that were the shareholders of record of the PFIC at any time during such year.

(ii) *The notification of PFIC information and request for shareholder certification.* The notification of PFIC information and request for shareholder certification statements are described below. The PFIC may modify these statements as it deems necessary provided the information contained in the following statements is transmitted to the PFIC shareholders. The PFIC information to be reported in the notification to shareholders includes information regarding the ordinary earnings and net capital gain of the PFIC. The PFIC may report the daily amount of its ordinary earnings and net capital gain on a per share basis. However, if the number of outstanding shares of the PFIC's stock changed at any time during the taxable year, the PFIC shall provide the shareholders a schedule of the per share amounts of ordinary earnings and net capital gain for each day during the taxable year. Each shareholder will determine its pro rata shares of the ordinary earnings and net capital gain of the PFIC based on the information provided by the PFIC. The information contained in paragraph I(F) of the notification statement, regarding the section 1291(d)(2) election, is not required if the PFIC made the election to be a QEF for its first taxable year during which it qualifies as a PFIC under section 1296.

"IMPORTANT TAX INFORMATION: RESPONSE REQUIRED NOTIFICATION OF QUALIFIED ELECTING FUND STATUS AND REQUEST FOR CERTIFICATION

I. Notification of Qualified Electing Fund Status

A. Earnings and profits: [*Name of the PFIC*] has elected to be a qualified electing fund for U.S. tax purposes for the taxable year beginning [*first day of the PFIC's taxable year*] and ending [*last day of the PFIC's taxable year*]. As a result of this election, all U.S. persons that are direct or indirect shareholders of [*name of the PFIC*] during any part of that taxable year must include in gross income for U.S. tax purposes their pro rata shares of ordinary earnings and net capital gain earned by [*name of the PFIC*] during the taxable year pursuant to section 1293 of the Internal Revenue Code. [The daily amounts of ordinary earnings and net capital gain per share of stock in [*name of the PFIC*] for the taxable year ended [*last day of the PFIC's taxable year*] are as follows; you are to compute your pro rata shares of ordinary earnings and net capital gain by multiplying the daily, per share amount of each type of income by the number of shares held by you during the year and the number of days held.] [Attached is a schedule of the per share amounts of ordinary earnings and net capital gain for each day during the taxable year of [*name of the PFIC*]; you are to compute your pro rata shares of ordinary earnings and net capital gain by multiplying each day's per share earnings amounts by the number of shares held on that day and then adding the daily ordinary earnings and net capital gain amounts.]

Ordinary Earnings: [[Daily dollar amount per share of stock] [See attached schedule of the per share dollar amounts, for each day,] of ordinary earnings as determined under section 1293].

Net Capital Gain: [[Daily dollar amount per share of stock] [See attached schedule of the per share dollar amounts, for each day,] of net capital gain as determined under section 1293].

B. [*Name of the PFIC*] distributed $ in cash and other property to you during its taxable year.

C. [*Name of the PFIC*] [was] [was not] a controlled foreign corporation within the meaning of section 957 of the Internal Revenue Code during the taxable year. Its subpart F income, as determined under section 951 for the taxable year, is ________.

D. [*Name of the PFIC*] [was] [was not] a foreign personal holding company within the meaning of section 552 of the Internal Revenue Code during the taxable year. Its undistributed foreign personal holding company income, as determined under section 556, is .

E. If any portion of your share of the current year earnings of [*name of the PFIC*] was not distributed to you during its taxable year and you owned the stock in [*name of the PFIC*] on [*the last day of the PFIC's taxable year*], you may be able to extend the time for payment of tax on some or all of this income under section 1294 of the Internal Revenue Code. See IRS Form 8621.

[Paragraph F is not required if the PFIC made the election to be a QEF for its first post-1986 taxable year that it qualifies as a PFIC under section 1296.]

F. If you were a U.S. person that was a direct or indirect shareholder of [*name of the PFIC*] on [*the first day of its first taxable year as QEF*], you may make the election under section 1291(d)(2) to recognize gain on a deemed sale of your stock in [name of the PFIC]. The fair market value of your stock interest, divided among the different classes of stock that you owned on that day, is as follows:

[Class of Stock]: $[fair market value determined in accordance with §1.1295-1T(b)(9)].

G. The U.S. taxpayer identification number assigned to [name of the PFIC] is ______________.

II. Request for Certification

U.S. persons that own stock directly or indirectly in [name of the PFIC] are requested to report to [*name of the PFIC*] by completing the following certification statement and returning it to the company. If additional space is needed, provide the required information on a separate sheet of paper and attach it to this form.

U.S. persons. If you are a U.S. citizen or individual resident, a U.S. corporation, or an estate, trust (other than a grantor trust, described below) or partnership that is a U.S. person for U.S. tax purposes, please complete the Certification Statement below and return it to [name of the PFIC] by [*date*].

Foreign persons. If you are a foreign corporation that is a passive foreign investment company, a foreign corporation that has a 50 percent or greater shareholder, or an estate, trust (other than a grantor trust, described below), or partnership that is not a U.S. person for U.S. tax purposes, please send this Notification of Qualified Electing Fund Status and Request for Certification to each of your shareholders (foreign corporations that are not passive foreign investment companies need only send the statement to their 50 percent or greater shareholder(s)), beneficiaries, or partners, indicating on the Notification of Qualified Electing Fund Status the amounts attributable to such person's indirect interest in [*name of the PFIC*]. (If you are unable to compute the amounts attributable to such person's indirect interest, please indicate the amounts attributable to your own interest in [*name of the PFIC*].

Grantor trusts. If you are a trust the income of which is taxed entirely to the grantor or other person considered the owner of the trust under U.S. tax principles, please send the Notification of Qualified Electing Fund Status and Request for Certification to the grantor/owner of the trust.

Nominees. If you are a U.S. or foreign person holding stock in [name of the PFIC] for the account of another person, please send this Notification of Qualified Electing Fund Status and Request for Certification to that other person, indicating on the Notification of Qualified Electing Fund Status the amounts attributable to such person's indirect interest in [*name of the PFIC*].

Each indirect shareholder that certifies to the PFIC that (he)(she)(it) is a U.S. person shall state (his)(her)(its) pro rata share of the ordinary earnings and net capital gain of the PFIC and pro rata share of the cash and the fair market value of other property distributed by the PFIC

CERTIFICATION STATEMENT

[*Name of direct or indirect PFIC shareholder (as reported on the U.S. tax return)*] is a U.S. citizen/U.S. individual resident/U.S. corporation/U.S. estate/U.S. trust/U.S. partnership/foreign trust/foreign estate (please circle applicable category) that held stock directly or indirectly in [*name of the PFIC*] during [*name of the PFIC*]'s taxable year ending . [*Name of direct or indirect shareholder*]'s address is , and United States taxpayer identification number is . [*Name of direct or indirect PFIC shareholder*]'s pro rata share of ordinary earnings is $_________, pro rata share of net capital gain is $, and pro rata share of the cash and the fair market value of other property distributed by [*name of the PFIC*] is . Stock in [*name of PFIC*] is not registered in the name of [*name of indirect PFIC shareholder*] because the stock was held through [*name(s) of nominee(s) or foreign person(s) through which stock was held indirectly*].

Under penalties of perjury, I declare that I have examined this certification and, to the best of my knowledge and belief, it is true, correct, and complete.

[Signature of shareholder/
authorized representative
of shareholder and title,
and date]."

(6) *Annual reporting by the PFIC to the Internal Revenue Service.* By the fifteenth day of the ninth month following each taxable year of the PFIC to which the election under this section applies, the PFIC shall send to the Internal Revenue Service Center, P.O. Box 21086, Philadelphia, Pennsylvania 19114:

(i) A schedule containing the following information obtained pursuant to the certification procedure described in §1.1295-1T(b)(5) from each direct or indirect shareholder that certified its status as a U.S. person: Names, addresses, taxpayer identification numbers, their pro rata shares (determined in the manner described in section 1293(b)) of the ordinary earnings and net capital gain of the PFIC for the taxable year determined in accordance with section 1293(e), and their pro rata shares of cash and fair market value of other property distributed to them or to the persons that held the stock directly or indirectly for their benefit.

(ii) For all taxable years of the PFIC following the year of the election, a Form 8644 (if available) or a statement containing the information described in paragraphs (b)(2)(ii) and (b)(6)(i) relating to information to be included in the election statement.

(7) *Amendment of earnings information.* The QEF shall report to the Internal Revenue Service, at the address specified in paragraph (b)(6) of this section, any amendments to the earnings information required to be provided to the Internal Revenue Ser-

vice pursuant to paragraphs (b)(2)(ii)(H) and (b)(6) of this section, and notify all its shareholders of any amendments to the earnings information reported to the shareholders pursuant to paragraph (b)(5). The QEF shall recalculate its ordinary earnings and net capital gain at any time that it discovers an error in its previous calculations or its books and records or otherwise makes a necessary adjustment in its books and records. The amended information shall be clearly identified as amending the original report or shareholder notification.

(8) *Taxpayer identification number.* The Internal Revenue Service will assign the PFIC a taxpayer identification number upon the filing of the PFIC's election to be a QEF. The PFIC shall use the assigned number on all forms, statements, notifications and other communications filed with the Internal Revenue Service or provided to its shareholders for purposes of the election under this section.

(9) *Fair market value determination by certain companies.* If a foreign corporation is making the election to be a QEF for a taxable year other than the first taxable year during which it qualified as a PFIC under section 1296, it must determine the fair market value of its stock on the first day of its first taxable year to which the election under section 1295 applies (the valuation date). A PFIC required to make the fair market value determination shall notify its shareholders of the stock value pursuant to paragraph (b)(5) of this section. This value is to be used by the shareholder in making the election under section 1291(d)(2) to recognize gain on a deemed sale of the PFIC stock held on the valuation date. For purposes of determining the fair market value of the stock in the PFIC, the following rules shall apply.

(i) *Companies other than open-end investment companies.* The fair market value of companies, other than open-end investment companies as defined in paragraph (b)(9)(ii)(B) of this section, shall be determined pursuant to subdivisions (A) through (E) of this paragraph (b)(9)(i).

(A) If the stock of the PFIC was regularly traded on an established securities market on the valuation date, the fair market value of the stock shall be the closing price of the stock on the valuation date. If there were no sales on the valuation date, but there were sales on dates within 30 business days before or after the valuation date, the fair market value shall be the mean of the opening and closing prices on the nearest date before or after the valuation date.

(B) If the stock of the PFIC was regularly traded in more than one established securities market, the price of the stock on a composite listing of all established securities markets in which it is regularly traded must be used, provided such a composite listing is set forth in a generally available listing or publication of general circulation. If such a composite listing is not available, the records of the price in the established securities market in which the stock is principally traded must be used.

(C) In any case in which a dividend is declared on a share of stock before the valuation date but payable to stockholders of record on a date after the valuation date, the amount of the dividend must be added to the ex-dividend quotation in determining the fair market value of the stock as of the valuation date.

(D) If the stock in the PFIC was not traded on an established securities market on the valuation date, or within 30 business days before or after the valuation date, the fair market value of the stock shall be the value determined by applying the guidelines of Rev. Rul. 59-60; 1959-1 C.B. 237, as amplified by Rev. Rul. 77-287, 1977-2 C.B. 319, Rev. Rul. 80-213, 1980-2 C.B. 101, and Rev. Rul. 83-120, 1983-2 C.B. 170.

(E) For purposes of this paragraph, the terms "established securities market" "regularly traded" shall have the meanings given such terms in §1.897-1(m) and (n), respectively. However, stock will not be treated as regularly traded if there was not a sale of the stock within 30 business days before or after the valuation date on an established securities market.

(ii) *Open-end investment companies*—(A) The fair market value of a share in a PFIC that is an open-end investment company (commonly known as a "mutual fund") shall be its public redemption price (or bid price) on the valuation date. If there is no public redemption price quoted by the PFIC for the valuation date, the fair market value of the mutual fund share is the last public redemption price quoted by the PFIC for the most recent day preceding the valuation date for which there was a quotation. In any case where a dividend is declared on a share in a PFIC that is an open-end investment company before the valuation date, but payable to shareholders of record after the valuation date and the share is quoted "ex-dividend" on the valuation date, the amount of the dividend must be added to the ex-dividend quotation in determining the fair market value of the share as of the valuation date.

(B) The term "open-end investment company" and the term "mutual fund" include only a company that on the applicable valuation date was engaged in offering its shares to the public in the capacity of an open-end investment company. An open-end investment company is an investment company that stands ready to redeem its shares, on demand, at their current net asset value.

(C) The term "public redemption price" and the term "bid" price mean the price (the current net asset value) at which the opened investment company will redeem its shares.

(c) *Revocability of the election*—(1) *In general.* The election under section 1295 may be revoked by the PFIC only with the consent of the Commissioner. In addition, the Commissioner may revoke the election for failure of the PFIC to satisfy any requirement set forth in this section within 90 days of the mailing of notification from the Internal Revenue Service of such failure. The revocation will be effective for the taxable year for which the requirement was not satisfied. The PFIC shall notify the U.S. persons that are its shareholders within 90 days of receipt of a notice from the Internal Revenue Service that the election under section 1295 has been revoked.

(2) *Failure to obtain shareholder certification.* The election under section 1295 will not be invalidated or revoked in the event a shareholder of the PFIC fails to provide the certification requested pursuant to paragraph (b)(5) of this section.

§1.1297-3T. Deemed sale election by a United States person that is a shareholder of a passive foreign investment company (Temporary).

(a) *In general.* Except as indicated below, a shareholder of a foreign corporation that no longer qualifies as a passive foreign investment company (PFIC) shall be treated for tax purposes as holding stock in a PFIC and therefore continue to be subject to taxation under section 1291 unless the shareholder makes the election under section 1297(b)(1). This continuing PFIC taint shall not apply to stock in a PFIC for which an election under section 1295 to be a qualified electing fund (QEF) has been in effect throughout that portion of the shareholder's holding period during which the PFIC qualified as a PFIC. A U.S. person making the election under section 1297(b)(1) shall be treated as having sold its stock in the PFIC on the last day of the last taxable year of the foreign corporation during which it qualified as a PFIC (termination date). The shareholder thereafter shall not be treated as holding stock in a PFIC and shall not be subject to taxation under section 1291. The deemed sale is taxed as a disposition under section 1291. Pursuant to that section, the gain, if any, is considered earned pro rata over the shareholder's holding period in the stock and is taxed as ordinary income. The tax on the gain is based on the value of the tax deferral and includes an interest charge. Any loss realized in the deemed sale may not be recognized. This section provides rules for making the election under section 1297(b)(1). The election is available to a U.S. person that is a shareholder of a foreign corporation if—

(1) The foreign corporation was a PFIC at any time during the period the U.S. person held the stock;

(2) At any one time during the U.S. person's holding period, the foreign corporation qualified as a PFIC but was not a QEF; and

(3) The foreign corporation is no longer a PFIC within the meaning of section 1296.

(b) *Time and manner of making the election*—(1) *In general.* The shareholder shall make the election under this section and section 1297(b)(1) by filing an amended income tax return for its taxable year that includes the termination date within three years of the due date, as extended, for the shareholder's tax return for such taxable year. The shareholder must attach to the amended return either Form 8621 or a statement, prepared in accordance with paragraph (c)(2) of this section, reporting the gain on the deemed sale of the stock as required by section 1291(a)(2) (as if such deemed sale occurred under section 1291(d)(2)), and by paying the tax on the gain as required by section 1291 (including the payment of the deferred tax amount required under sections 1291(a)(1)(C) and 1291(c)). The electing shareholder also shall pay interest, pursuant to section 6601, on the underpayment of tax for the taxable year of termination. An electing shareholder that realizes a loss shall report the loss on Form 8621, but shall not recognize the loss.

(2) *Information to be included in the election.* If a statement is used, the statement should be identified, in a heading, as an election under section 1297(b)(1). The statement must include the following information and representations:

(i) The name, address and taxpayer identification number of the electing shareholder;

(ii) The name, address and taxpayer identification number, if any, of the PFIC;

(iii) A statement that the shareholder is making the election under section 1297(b)(1);

(iv) The period in the electing shareholder's holding period in the stock during which the foreign corporation was a PFIC, the period during which it was a QEF (and whether the shareholder elected under section 1294 to defer payment of its tax liability attributable to any portion of such period), and the termination date;

(v) The manner in which the PFIC lost the characteristics of a PFIC;

(vi) A schedule listing the shares in the PFIC held by the electing shareholder on the termination, listing the date(s) each share or block of shares acquired, the number of shares acquired on each date listed, and the tax basis of each share;

(vii) The fair market value of the stock in the PFIC on the termination date; for this purpose, the fair market value of the stock shall be determined according to the rules of §1.1295-1T(b)(9); and

(viii) A schedule showing the computation of the gain recognized on the deemed sale, and a calculation of the deferred tax amount, as defined in section 1291(c).

(3) *Adjustment to basis; treatment of holding period.* An electing shareholder that recognizes gain on the deemed sale of stock shall increase its adjusted basis in the stock by the amount of gain recognized. An electing shareholder shall not adjust the basis in stock with respect to which the shareholder realized a loss on the deemed sale. An electing shareholder shall thereafter treat its holding period in the stock, for purposes of sections 1291 through 1297, as beginning on the day following the termination date without regard to whether it recognized gain on the deemed sale; for section 1223 purposes, the holding period in the stock in the PFIC shall include the period prior to the deemed sale.

OMB CONTROL NUMBER UNDER THE PAPERWORK REDUCTION ACT (26 CFR Part 602)

Par. 3. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. Section 602.101(c) is amended by inserting in the appropriate places in the table §1.1291-0T . . . 1545-1028, §1.1291-10T . . . 1545-1028, §1.1294-1T . . . 1545-1028, §1.1295-1T . . . 1545-1028, §1.1297-3T . . . 1545-1028.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved February 23, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on February 26, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 2, 1988, 53 F.R. 6770)

Subchapter S.—Tax Treatment of S Corporations and Their Shareholders
Part I.—In General

Section 1363.—Effect of Election on Corporation

Procedures for taking into account the effect of S elections during the adjustment period when consent to discontinue the use of the last-in, first-out (LIFO) inventory method is granted. See Rev. Proc. 88-15, page 683.

Chapter 3.—Withholding of Tax on Nonresident Aliens and Foreign Corporations
Subchapter A.—Nonresident Aliens and Foreign Corporations

Section 1441.—Withholding of Tax on Nonresident Aliens

26 CFR 1.1441-2: Income subject to withholding.

Whether income from certain United States investments allocable to superannuation funds owned by local governmental bodies in England, Wales, and Scotland is exempt from United States withholding tax. See Rev. Rul. 88-7, page 269.

26 CFR 1.1441-2: Income subject to withholding.

For reduced rates of withholding tax on scholarships or grants paid to nonresident alien students or grantees. See Rev. Proc. 88-24, page 800.

Section 1442.—Withholding of Tax on Foreign Corporations

26 CFR 1.1442-1: Withholding of tax on foreign corporations.

Whether income from certain United States investments allocable to superannuation funds owned by local governmental bodies in England, Wales, and Scotland is exempt from United States withholding tax. See Rev. Rul. 88-7, page 269.

Subchapter B.—Application of Withholding Provisions

Section 1461.—Liability for Withheld Tax

26 CFR 1.1461-2: Return of tax withheld.

For reduced rates of withholding tax on scholarships or grants paid to nonresident alien students or grantees. See Rev. Proc. 88-24, page 800.

Chapter 6.—Consolidated Returns
Subchapter A.—Returns and Payment of Tax

Section 1502.—Regulations

26 CFR 1.1502-13: Intercompany transactions.

T.D. 8196

TITLE 26.—INTERNAL REVENUE—CHAPTER 1, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1986

Consolidated Return Regulations—Deferral of Gain or Loss

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary and final regulations.

SUMMARY: This document contains temporary and final regulations that amend §1.1502-13, §1.1502-14, §1.1502-13T and add new §1.1502-14T to the consolidated return regulations. The temporary and final regulations supplement the existing regulations by providing rules relating to complete liquidations of subsidiaries that are taxable to the distributing corporation. The text of the temporary and final regulations set forth in this document also serves as the text of the proposed regulations *** [LR-47-88, page 935, this Bulletin].

EFFECTIVE DATE: These regulations are effective upon publication and apply to consolidated income tax returns for which the due date (without extensions) is after April 14, 1988.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document adds new temporary regulations §1.1502-14T to Part 1 of Title 26 of the Code of Federal Regulations and makes conforming amendments to §§1.1502-13T, 1.1502-13 and 1.1502-14. The temporary regulations added by this document will remain in effect until superseded by later temporary or final regulations relating to these matters.

EXPLANATION OF PROVISION

Under §1.1502-14(c)(2) of the consolidated return regulations, any gain recognized by the distributing corporation on a complete liquidation is accounted for as if the distributing and distributee member corporations filed separate returns. Because a distribution in complete liquidation of a member of a group is not a "deferred intercompany transaction" (see §1.1502-13(a)) and is not otherwise treated as such (see §§1.1502-14(c)(1) and (2)), any gain or loss recognized by the distributing corporation in a transaction described §1.1502-14(c)(2) is taken into account in the taxable year in which the transaction occurs.

Under subchapter C of the Internal Revenue Code of 1986 and the consolidated return regulations, the Internal Revenue Service is unaware of any circumstance in which gain or loss recognized by the distributing corporation in a complete liquidation should not be deferred in the same manner as is provided for other distributions described in §1.1502-14(a) and (b). *See also* H.R. Rep. No. 100-495, 100th Cong., 1st Sess. 969 (1987). Accordingly, temporary regulation §1.1504-14T is added, and related temporary regulation §1.1502-13T is amended, to provide for the deferral of any gain or loss recognized by the distributing corporation on any complete liquidation to the same extent that deferral is provided for gain recognized with respect to a nonliquidating distribution under section 311. The temporary regulations under new §1.1502-14T, and the amended related regulations under §1.1502-13T, generally apply to distributions in complete liquidation of a corporation that occur during a taxable year for which the due date (without extensions) for the filing of the income tax return is after April 14, 1988.

SPECIAL ANALYSES

A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6). The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

PART 1—INCOME TAX;
TAXABLE YEARS BEGINNING
AFTER DECEMBER 31, 1986

Paragraph 1. The authority citation for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805; *** §§1.1502-13, 1.1502-13T, 1.1502-14, and 1.1502-14T also issued under 26 U.S.C. 1502.

Par. 2. Section 1.1502-13 is amended as follows:

1. A new paragraph (c)(7) is added to read as set forth below.

2. A new paragraph (f)(2)(iii) is added to read as set forth below.

§1.1502-13 Intercompany transactions.

* * * * *

(c) ***

(7) *Cross reference to temporary regulations.* For rules relating to inheritance of deferred gain or loss in the case of acquisitions in taxable years for which the due date (without extensions) of the income tax return is after April 14, 1988, see §1.1502-13T(c).

* * * * *

(f) ***

(2) ***

(iii) See §1.1502-13T(f) for a modification of an exception to paragraph (f)(1)(iii) of this section.

* * * * *

Par. 3. Paragraphs (c) and (f) of §1.1502-13T are added to read as follows:

§1.1502-13T Temporary regulations for certain intercompany transactions.

(a)—(b) [Reserved.]

(c) *Deferral of gain or loss on intercompany transactions*—(1) *Inheritance of deferred gain or loss.* If the assets of the selling member are acquired by one or more other members in an acquisition to which section 381(a) applies, or pursuant to a distribution in a complete liquidation not described in section 332(b), the member acquiring the greatest portion of the assets (measured by fair market value) of the selling member shall be subject to the provisions of §1.1502-13(d), (e), and (f) with respect to the entire remaining balance of the deferred gain or loss. If two or more members acquire the same portion (which is greater than that acquired by any other members), the common parent shall select which such member shall be subject to the provisions of §1.1502-13(d), (e), and (f). For purposes of this section and §1.1502-13, a member which inherits the balance of the deferred gain or loss under this subparagraph (1) shall be treated as the selling member.

(2) *Effective date.* Paragraph (c)(1) of this section applies, and §1.1502-13(c)(6) does not apply, to acquisitions of assets by one or more members from another member in taxable years for which the due date (without extensions) of the income tax return is after April 14, 1988. In the case of a transaction to which this paragraph (c) applies, a reference in this part to §1.1502-13(c) is treated as including a reference to this paragraph (c).

(d)—(e) [Reserved.]

(f) *Restoration of deferred gain or loss on dispositions, etc.*—(1) *Exception to general rule of §1.1502-13(f)(1)(iii).* Section 1.1502-13(f)(1)(iii) shall not apply in a case where the selling member or the member which owns the property, as the case may be, ceases to be a member of the group by reason of an acquisition to which section 381(a) applies, or pursuant to a distribution in a complete liquidation not described in section 332(b), and the acquiring corporation is a member.

(2) *Effective date.* Paragraph (f)(1) of this section applies, and §1.1502-13(f)(2)(ii)(a) does not apply, when the selling member or the member which owns the property ceases to be a member of the group in a taxable year for which the due date (without extensions) of the income tax return is after April 14, 1988. In the case of a transaction to which this paragraph (f) applies, a reference in this part to §1.1502-13(f) is treated as including a reference to this paragraph (f).

(g)—(j) [Reserved.]

* * * * *

Par. 4. Section 1.1502-14 is amended by adding a new paragraph (c)(3) to read as follows:

§1.1502-14 Stock, bonds, and other obligations of members.

* * * * *

(c) ***

(3) *Cross-reference to temporary regulations.* For distributions in taxable years for which the due date (without extensions) of the income tax return is after April 14, 1988, see §1.1502-14T.

* * * * *

Par. 5. There is added immediately after §1.1502-14 a new §1.1502-14T to read as follows:

§1.1502-14T Treatment of distributing corporation (temporary).

(a) *Deferral of gain or loss.* To the extent gain or loss is recognized to the distributing corporation on a distribution described in §1.1502-14 (a) or (b) (including any amount which is treated as gain under sections 311, 336, 341(f)(2), 453B, 1245(a)(1) or 1250(a)(1)), such gain or loss shall be deferred by the distributing corporation. Such deferred gain or loss shall be taken into account by the distributing corporation at the time and in the manner specified in §1.1502-13(d), (e), and (f), as if such distributing corporation were a "selling member" and the distributee were a "purchasing member."

(b) *Effective date.* Paragraph (a) of this section applies, and §1.1502-14(c) does not apply, to distributions described in §1.1502-14 (a) or (b) that occur in taxable years for which the due date (without extensions) of the income tax return is after April 14, 1988. In the case of a transaction to which this section applies, a reference in this part to §1.1502-14(c) is treated as including a reference to this section.

The provisions contained in this Treasury Decision are needed to immediately amend the consolidated return regulations in response to amendments made by the section 10223 of the Revenue Act of 1987. It is therefore found impracticable and contrary to the public interest to issue this Treasury Decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved April 12, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 14, 1988, 8:45 a.m., and published in the issue of the Federal Register for April 18, 1988, 53 F.R. 12678)

26 CFR 1.1502-32T: Investment adjustments (temporary).

T.D. 8188

TITLE 25.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Consolidated Return Regulations—Adjustment on Disposition of Stock of Subsidiary

AGENCY: Internal Revenue Service, Treasury

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that add new §1.1502-32T to the consolidated return regulations. The temporary regulations supplement the adjustment under §1.1502-32(g) on the disposition by a member of stock of a subsidiary. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations *** [page 933, this Bulletin].

EFFECTIVE DATE: These regulations are effective for stock of a subsidiary that ceases to be a member of an affiliated group filing a consolidated return during a taxable year of the group ending after November 30, 1987. A member may elect to apply the new rules to stock not otherwise covered by such rules if the stock is disposed of in a taxable year ending after November 30, 1987.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document adds temporary regulations §1.1502-32T to Part 1 of Title 26 of the Code of Federal Regulations. The temporary regulations added by this document will remain in effect until superseded by later temporary or final regulations relating to these matters.

GENERAL DESCRIPTION

Section 1.1502-32(g) of the consolidated return regulations provides that when a subsidiary in a group filing a consolidated return leaves the group, members of the group owning stock in the subsidiary must reduce the basis of such stock by the excess of the net positive adjustments for all consolidated return years over the net negative adjustments for all consolidated return years. The reduction is made on the first day of the subsidiary's first separate return year, and it applies only to stock retained by members. Section 1.1502-32(g) also applies if a member that owns stock in a subsidiary leaves the group. The purpose of the reduction is to prevent artificial losses when the stock retained by the member is subsequently sold.

Members of a group filing a consolidated return are subject to the investment adjustment rules of §1.1502-32. These investment adjustment rules require that the basis of the stock of subsidiary members be increased to reflect undistributed earnings and profits and decreased upon the distribution of these earnings and profits. The effect of the investment adjustment rules is to ensure that the income and loss of members of a consolidated group are taken into account only once in computing the taxable income of the group. Without §1.1502-32(g), during a separate return year a subsidiary could distribute consolidated earnings and profits without the members making a corresponding reduction in the basis of their retained stock. Thus in separate return years, members would retain the high basis in the subsidiary's stock that they obtained through positive investment adjustments for earnings and profits during the consolidated years. Absent the §1.1502-32(g) reduction in basis, a separate return year distribution of the subsidiary's consolidated earnings and profits would set the stage for an artificial loss on the sale of the subsidiary's stock.

For example, assume that in 1986, corporation P forms subsidiary S with $100 capital. In 1986 and 1987, P and S file consolidated returns and S has earnings and profits of $200. On the last day of 1987, P's basis in the stock of S is $300 (due to the investment adjustment rules of §1.1502-32). On December 31, 1987, P sells one-half of its S stock to corporation X, a nonmember, for $150. P has no gain on this sale ($150 amount realized less $150 basis in one-half S stock). On January 1, 1988, P's basis in its remaining S stock is reduced by $100 under the provisions of §1.1502-32(g) (the portion of the $200 positive investment adjustment resulting from S's earnings that is attributable to P's remaining 50 percent stock ownership in S).

Absent §1.1502-32(g), S could create an artificial loss by distributing its $200 earnings and profits ($100 to P and $100 to X) on January 1, 1988. P would not be required to make a negative adjustment to its basis in its remaining S stock to reflect this distribution, since S would no longer be a member of the P group and therefore would not be subject to the investment adjustment rules of §1.1502-32. P's basis in the S stock it retained would remain $150, even though the value of the S stock held by P would be $50 following the distribution. Therefore, P could sell its remaining S stock for $50 and recognize a $100 loss on the sale.

Section 1.1502-32(g) prevents a distribution of consolidated earnings and profits by a subsidiary after disaffiliation from creating the potential for a subsequent artificial loss on the sale of the subsidiary's stock, by requiring a reduction in the basis of the stock at the time of disaffiliation. However, the reduction that §1.1502-32(g) requires may cause harsh results in certain situations because the basis adjustment occurs at the time of disaffiliation, whether or not dividend stripping subsequently occurs.

To avoid the effect of §1.1502-32(g), consolidated groups have utilized the deemed dividend provisions of §1.1502-32(f)(2). Under §1.1502-32(f)(2), a group may capitalize the earnings and profits of a subsidiary by treating the earnings and profits as distributed to the parent and immediately contributed by the parent to the capital of the subsidiary. After a deemed dividend, there generally is no net positive adjustment remaining in the stock of the subsidiary. Instead, the basis of the subsidiary's stock has been increased by the deemed capital contribution. There is no need to apply §1.1502-32(g), since there are no longer any earnings and profits in the subsidiary.

The deemed dividend, however, is available only to groups that own 100 percent of the subsidiary's stock on each day of its taxable year. Also, since a deemed dividend applies to the subsidiary's earnings and profits account as of the last day of the prior taxable year, it cannot be used to capitalize earnings and profits accumulated in the final consolidated return year. Groups that own subsidiaries with minority shareholders have used the consent dividend provisions of section 565 as a substitute for the deemed dividend provisions. Groups also have used the consent dividend to capitalize the earnings and profits of the subsidiary for its final consolidated return year. T.D. 8166, [page 254, this Bulletin] published December 15, 1987, restricts the use of consent dividends under section 565 to corporations that are subject to the accumulated earnings tax, personal holding companies, foreign personal holding companies, regulated investment companies, and real estate investment trusts. Because of the restrictions placed upon the use of consent dividends by T.D. 8166, most groups do not qualify to use consent dividends.

EXPLANATION OF PROVISION

The temporary regulations do not change the amount of the adjustment, and they continue to treat the portion of the adjustment in excess of the basis of the adjusted stock as immediately includible in income as income described in §1.1502-19(a). The temporary regulations, however, do not immediately reduce basis when a subsidiary (or a member that owns the subsidiary's stock) leaves the group. Instead, the basis reduction is deferred, generally until the subsidiary makes a distribution that would have cause a reduction in the basis of its stock had affiliation continued to exist.

The deferral of the basis reduction is accomplished through the establishment of a basis reduction account that applies to the stock of the subsidiary retained by the member. The basis reduction account also applies to any stock acquired by the member in exchange for the disaffiliated subsidiary's stock if the acquired stock has a substituted basis in the hands of the member. In addition, it continues to apply if the stock is transferred to another member. However, if the stock is transferred to a nonmember corporation that is related to the transferor corporation within the meaning of section 304, the basis of the stock is reduced, immediately before the transfer, by the amount of the basis reduction account, and the basis reduction account is eliminated. A special rule provides for the elimination of a basis reduction account when a nonmember whose stock is subject to the basis reduction account becomes a member.

An anti-duplication rule is provided to deal with cases where a distribution of earnings and profits would result in reductions in basis under both the temporary regulations and other provisions of the Code and regulations.

The regulations also provide that members owning stock of a subsidiary that ceased to be a member of the group in a taxable year ending on or before November 30, 1987, may elect to apply the new rules to stock disposed of in a taxable year of the group ending after November 30, 1987. Taxpayers that make this election must certify that they have the information necessary to determine these adjustments.

SPECIAL ANALYSES

A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6). The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required. The collection of information requirements contained in these regulations have been submitted to the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act of 1980. These requirements have been approved by OMB (Control number 1545-1046).

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority citation for Part 1 is amended by adding the following citations:

Authority: 26 U.S.C. 7805. *** §1.1502-32T also issued under 26 U.S.C. 1502.

Par. 2. Section 1.1502-32 is amended by adding paragraph (g)(4) to read as follows:

§1.1502-32 (Amended)

*****

(g) ***

(4) For dispositions of stock in taxable years ending after November 30, 1987 see §1.1502-32T.

Par. 3. There is added immediately after §1.1502-32 a new §1.1502-32T to read as follows:

§1.1502-32T Investment adjustments (temporary)

(a) *Adjustment on disposition*—(1) *Amount of adjustment*. A member owning stock in a subsidiary shall determine the net basis increase in each share of such stock that the member owns on the first day of the first separate return year of the member or of the subsidiary, whichever occurs first. The net basis increase is the excess with respect to such share of—

(i) The net positive adjustments under §1.1502-32(e)(2) for all consolidated return years, over

(ii) The net negative adjustments under §1.1502-32(e)(1), plus any decreases under §1.1502-32(f)(1)(i), for all consolidated return years.

(2) *Amount taxable*. If the net basis increase with respect to a share exceeds the basis of the share, the amount of the excess shall, as of the day immediately preceding such first day, be included in the income of the member as income described in §1.1502-19(a).

(3) *Basis reduction on distribution*—(i) *General rule*. The amount of the net basis increase not included in income under paragraph (a)(2) is treated as a "basis reduction account." If subsequently there is a dividend distribution with respect to the share, the basis of the share is reduced under this section by the amount of the distribution, but only to the extent of the basis reduction account for that share. The basis reduction account

is decreased by distributions to which the preceding sentence applies.

(ii) *Anti-duplication rule; earnings and profits adjustments.* Adjustments under paragraph (a)(3)(i) of this section to the basis of a share for distributions shall not duplicate adjustments otherwise applicable to the same distributions, such as adjustments under §1.1502-32(b)(2)(iii) with respect to the consolidated return of another group. If the preceding sentence applies because of a reduction under §1.1502-32, the basis reduction account is decreased, except to the extent a distribution is attributable to earnings and profits earned after the establishment of the basis reduction account. Appropriate adjustments shall also be made with respect to the earnings and profits of each member.

(4) *Special rules*—(i) *Nonmember becomes a member.* If a nonmember whose stock is subject to a basis reduction account becomes a member of the group with respect to which the net basis increase under paragraph (a)(1) of this section was determined, the basis reduction account for the stock is eliminated.

(ii) *Dispositions of stock subject to a basis reduction account*—(A) *In general.* Except as provided in paragraph (a)(4)(ii)(B) and (C) of this section, if stock subject to a basis reduction account is disposed of by a member, the basis reduction account is eliminated.

(B) *Exchanges in substituted basis transactions.* If a member exchanges stock subject to a basis reduction account for stock of another corporation, and the member's basis in the stock received in the exchange is determined in whole or in part by reference to the member's basis in the stock exchanged, the stock received becomes subject to the basis reduction account, and the rules of this section apply to the stock received as if it were the stock exchanged. For purposes of the preceding sentence, a reorganization described in section 368(a)(1)(F) shall be considered to result in an exchange.

(C) *Transfers to members.* Stock that is subject to a basis reduction account in the hands of a transferor member will continue to be subject to the basis reduction account in the hands of a transferee member.

(D) *Reduction of basis in certain transactions.* If stock that is subject to a basis reduction account is transferred to a nonmember, and the nonmember is controlled by the transferor within the meaning of section 304(c), the basis of the stock is reduced, immediately before the transfer, by the amount of the basis reduction account at that time and the basis reduction account is eliminated.

(iii) *Exchange of member stock for nonmember stock creating a basis reduction account.* If a member exchanges stock of a member subsidiary for stock of a nonmember, and the member's basis in the stock received in the exchange is determined in whole or in part by reference to the member's basis in the stock exchanged, then the stock of the nonmember shall be treated as becoming subject to this section as a result of the exchange, as if the member subsidiary had become a nonmember immediately before the exchange.

(5) *Example.* The following example illustrates the application of paragraph (a) of this section.

Example: (i) Corporation P forms corporation S with a capital contribution of $100. P and S file a consolidated return for 1987. S has $100 of earnings and profits for 1987, which increases P's basis in the S stock by $100. On January 1, 1988, X, the common parent of an unrelated group, buys all the stock of P, and P and S are included in the consolidated return of the X group for 1988. During 1988, S has earnings and profits of zero, and it distributes $10 to P. On January 1, 1989, P sells all of the stock of S to an unrelated purchaser.

(ii) Under paragraph (a)(1) of this section, P must determine its net basis increase in the stock of S as of the first day of P's or S's first separate return year. Under §1.1502-1(e), consolidated return years of the X group are separate return years of the P group, and the computation is therefore made as of January 1, 1988. The net basis increase is $100. Since this amount is less than $200, the basis of the stock, no amount is taxable under paragraph (a)(2) of this section. The basis of the S stock is not reduced under this section on January 1, 1988, but a basis reduction account is established under paragraph (a)(3)(i) of this section in the amount of $100.

(iii) The $10 distribution by S is a distribution to which this section applies, since (from the standpoint of the former P group) it is a dividend distribution to a member with respect to stock of a subsidiary for which there is a basis reduction account. However, the distribution also results in a basis reduction in the stock of S under §1.1502-32(b)(2)(iii)(c), since (from the standpoint of the X group) it is a distribution of earnings and profits accumulated in separate return years of S. Under paragraph (a)(3)(ii) of this section, the reduction under paragraph (a)(3)(i) is not made, and since the distribution is not attributable to earnings and profits earned after the basis reduction account was established, the basis reduction account is decreased from $100 to $90.

(iv) P's basis for determining gain or loss on the sale of the S stock is $190. The remaining $90 basis reduction account in the stock is eliminated under paragraph (a)(4)(ii)(A) of this section as a result of P's sale of the stock.

(b) *Effective date*—(1) *General Rule.* Paragraph (a) of this section applies, and §1.1502-32(g) does not apply, to stock of a subsidiary that ceases to be a member of a group during a taxable year of the group ending after November 30, 1987.

(2) *Election to apply paragraph (a).* A member owning shares of stock of a subsidiary to which paragraph (a) of this section does not apply, may elect to have paragraph (a) and not §1.1502-32(g) apply to shares disposed of in a taxable year of the group ending after November 30, 1987. The election shall contain a certification that the member has the information necessary to determine the adjustments required by paragraph (a) of this section. The election is made by attaching a statement to the return of the member for the taxable year in which the stock is disposed of. To the extent that the basis of stock is increased pursuant to an election under this paragraph (b)(2), appropriate adjustments shall be made to the earnings and profits of each member for the taxable year in which the election is made and subsequent years to reflect such increase in basis and, as appropriate, adjustments later made to the basis reduction account.

The provisions contained in this Treasury Decision are needed to immediately amend the consolidated return regulations in response to the restrictions placed upon the use of consent dividends by temporary regulations under section 565. It is therefore found impracticable and contrary to the public interest to issue this Treasury Decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved March 14, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 14, 1988, 5:14 p.m., and published in the issue of the Federal Register for March 17, 1988, 53 F.R. 8747)

Chapter 11.—Estate Tax
Subchapter A.—Estates of Citizens or Residents
Part IV.—Taxable Estate

Section 2055.—Transfers For Public, Charitable, and Religious Uses

26 CFR 20.2055-2: Transfers not exclusively for charitable purposes.

Does a charitable "lead" annuity interest qualify as a guaranteed annuity interest if the trustee has the discretion to commute and prepay the charitable interest prior to the expiration of the specified term of the annuity. See Rev. Rul. 88-27, page 331.

Section 2056.—Bequests, Etc., to Surviving Spouse

26 CFR 20.2056(b)-4: Marital deduction; valuation of interest passing to surviving spouse.

Marital deduction; South Carolina; liability of residuary share for debts and expenses. For purposes of computing the marital deduction for residents of South Carolina dying after 1978, the surviving spouse's share of the residuary interest is reduced by the expenses and debts allocated by South Carolina law to such shares but is not reduced by state and federal death taxes. Rev. Rul. 78-419 obsolete for estates of decedents dying after 1978.

Rev. Rul. 88-12

ISSUE

If a resident of South Carolina dies after 1978 and the decedent's will contains no provision for the apportionment of debts, expenses, or death taxes, is the value of property interests bequeathed to the surviving spouse under the residuary clause of the will reduced by a portion of those debts, expenses and taxes for purposes of determining the amount of the deduction allowed under section 2056 of the Internal Revenue Code?

FACTS

The decedent, *D*, a resident of South Carolina, died testate in 1982, survived by *S*, *D*'s spouse, and *A* and *B*, *D*'s children. The decedent's will contained specific and general bequests and a residuary clause. Under the residuary clause, *D* gave one-half of the residue to *S* and divided the remaining one-half evenly between *A* and *B*. Although *D*'s will directed that the debts and administration expenses be paid promptly, it did not contain any provision for the apportionment among the beneficiaries of payment of debts, expenses, and any death taxes. Both federal and state death taxes were imposed on *D*'s estate. The residuary bequest to *S* qualifies for the estate tax marital deduction under section 2056 of the Code.

In 1978, South Carolina amended its statute concerning the method of determining the value of the taxable estate for state estate tax purposes. The amended statute is effective for estates of decedents dying after December 31, 1978. With respect to the apportionment of debts and expenses, the statute provides that, in the absence of a provision in a decedent's will to the contrary, in determining the net marital deduction allowable for South Carolina estate tax purposes in either an intestate situation or a testate situation involving a residuary share, the intestate or testate share passing to a surviving spouse shall be liable for, and charged with, a pro rata share of debts, funeral expenses, and expenses of administration. The amount charged against the spouse's share is the proportion that the value of the intestate share or the testate share of the residuary estate passing to a surviving spouse bears to the value of the total intestate estate or total residuary estate before reduction for debts and expenses. *See* S.C. Code Ann. sec. 12-15-60(1) (Law. Co-op. Supp. 1986).

Regarding the apportionment of state and federal death taxes, the statute was also amended to provide that, in the absence of a provision in the decedent's will to the contrary, the intestate share or testate share of the residuary estate passing to a surviving spouse will not be charged with any death taxes, state or federal, to the extent that the share qualifies for the statutory marital deduction. *See* S.C. Code Ann. *supra*, sec. 12-15-60(2).

The South Carolina estate tax law adopts by reference the deductions allowed for purposes of the federal estate tax including the marital deduction allowed under section 2056 of the Code. *See* S.C. Code Ann. *supra*, sec. 12-15-60.

In this situation, *D*'s will made no provision for the apportionment of debts, expenses, and taxes. Therefore, pursuant to S.C. Code Ann. sec. 12-15-60, *D*'s executor charged *S*'s one-half share of the residue with one-half of the estate debts and expenses. Also pursuant to state law, *S*'s share of the residue was not charged with any state or federal estate taxes. Accordingly, *D*'s executor distributed to *S*, in satisfaction of *S*'s residuary bequest, an amount equal to one-half of the residue less one-half of the estate debts and expenses. The executor deducted this amount as the marital deduction under state and federal law.

LAW AND ANALYSIS

Section 2001(a) of the Code imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2056(a) of the Code provides that the value of the taxable estate shall be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes from the decedent to the decedent's surviving spouse. Section 2056(b)(4)(A) provides that in determining the value of any interest in property passing to the surviving spouse for the purpose of the deduction granted by section 2056(a), there shall be taken into account the effect that the federal estate tax imposed by section 2001 of the Code, or any other estate, succession, legacy or inheritance tax, has on the net value of such interest. Section 2056(b)(4)(B) provides that where the interest in property passing to the surviving spouse is encumbered in any manner or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, the encumbrance or obligation must be taken into account in valuing the spouse's interest.

In ascertaining the net value of the interest passing to the surviving spouse for purposes of determining the allowable marital deduction, applicable state law is determinative of the extent to which federal and state death taxes and debts and expenses are chargeable against the spouse's interest. *See Estate of Milliken v. Commissioner*, 70 T.C. 883 (1978), *acq.*, 1979-1 C.B. 1.

Since *D* was a resident of South Carolina and *D*'s estate is administered in South Carolina, it is necessary to look to South Carolina law to determine whether the interests in property passing to *S* under the residuary clause are charged with a portion of the debts, expenses, and taxes of *D*'s estate.

Rev. Rul. 78-419, 1978-2 C.B. 244, considers the application of South Carolina law, as in effect prior to the amendments discussed above, to a situation similar to that presented here. In Rev. Rul. 78-419, the surviving spouse was bequeathed a portion of the residuary estate and the will was silent regarding the apportionment of debts and expenses. The revenue ruling concludes that, under South Carolina law applicable prior to 1979, the surviving spouse's share of the residue was not chargeable with any estate debts and expenses, to the extent the spouse's interest qualified for the marital deduction under state and federal law. Accordingly, the amount passing to the surviving spouse, and consequently the allowable marital deduction, was based on the spouse's share of the residue without reduction for any debts and expenses.

However, under S.C. Code Ann. sec. 12-15-60, as currently in effect, the spouse's share of the residue is, under the circumstances presented here, chargeable with a pro rata share of estate debts and expenses but is not chargeable with any portion of the federal or state estate tax liability. Accordingly, since *S* was bequeathed one-half of the residue, *D*'s executor properly determined the amount passing to *S* under state law by charging *S*'s one-half share with one-half of the estate debts and expenses. Further, since *S*'s residuary bequest qualified for the marital deduction under state and federal law, *S*'s share was not reduced by any state or federal estate taxes. The amount of the allowable marital deduction under section 2056 was correctly determined based on the amount to *S* under applicable South Carolina law.

HOLDING

If a resident of South Carolina dies after 1978, and the decedent's will contains no provision for the apportionment of debts, expenses, or death taxes, then the value of the property interests passing to the surviving spouse under the residuary clause of the will is reduced by a pro rata portion of the estate debts and expenses, but not by any death taxes, for purposes of determining the amount of the marital deduction allowed under section 2056 of the Code.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 78-419 is obsoleted for estates of decedents dying after December 31, 1978.

Chapter 12.—Gift Tax
Subchapter C.—Deductions

Section 2522.—Charitable And Similar Gifts

26 CFR 25.2522(c)-3: Transfers not exclusively for charitable, etc., purposes in the case of gifts made after July 31, 1969.
(Also Sections 170, 2055; 1.170A-6, 20.2055-2.)

Charitable transfers; "lead" annuity interest; guaranteed prepayment. A charitable "lead" interest does not qualify as a guaranteed annuity interest under section 2552(c)(2)(B) of the Code if the trustee has the discretion to commute and prepay the charitable interest prior to the expiration of the specified term of the annuity.

Rev. Rul. 88-27

ISSUE

Does a charitable "lead" annuity interest qualify as a guaranteed annuity interest under section 2522(c)(2)(B) of the Internal Revenue Code if the trustee has the discretion to commute and prepay the charitable interest prior to the expiration of the specified term of the annuity?

FACTS

In 1986, *A*, the donor, transferred $1,000x to an irrevocable trust. The terms of the trust provide that an annuity of $60x per year is to be paid for a period of 10 years to *X* Charity, a corporation described in section 2522(a) of the Code. Upon the expiration of the 10 year period, the trust is to terminate and the remaining corpus is to be paid to *A*'s child, *B*. Under the terms of the trust, the trustee is granted the discretion to use trust income or principal to commute and prepay the future annuity payments due *X* Charity. The trust instrument also provides that the prepayment amount shall be based on the discount rate and methodology used to calculate the present value of annuity payments under the Code and the Gift Tax Regulations in effect at the time of the prepayment.

LAW AND ANALYSIS

Section 2522(a) of the Code provides, in part, that in computing taxable gifts, a deduction is allowed for the amount of all transfers to or for the use of a corporation organized and operated exclusively for charitable purposes.

Section 2522(c)(2) of the Code provides, in part, that where a donor transfers an interest in property to or for a charitable purpose and an interest in the same property passes to or for a noncharitable use, then no deduction is allowed under section 2522(a) unless the charitable transfer is in certain prescribed forms.

Section 2522(c)(2)(B) of the Code provides, in part, that, in the case of a charitable "lead" interest (i.e., any interest, other than a remainder interest, transferred for the use described in section 2522(a)), the interest must be in the form of a guaranteed annuity.

Section 25.2522(c)-3(c)(2)(vi) *(a)* of the regulations, in part, defines a guaranteed annuity as an arrangement under which a determinable amount is paid, at least annually, for a specified term. An amount is determinable if the exact amount which must be paid under the conditions specified in the instrument of transfer can be ascertained as of the date of the gift. On the other hand, that subdivision of the regulations provides, by means of an example, that an amount is not determinable if the payments may be redetermined after the date of the gift by reference to a fluctuating index which cannot be determined as of the date of the gift.

The issue presented in this case is whether *A*'s transfer to *X* Charity satisfies the definition of a guaranteed annuity.

Under section 2522(c)(2)(B) of the Code and section 25.2522(c)-3(c)(2)(vi)(*a*) of the regulations, a guaranteed annuity must, at least, satisfy the following two requirements: (1) the annuity must represent the right to receive periodic payments over a specified period of time, and (2) the exact amount payable under the annuity must be determinable as of the date of the gift.

Although the charitable annuity created by *A* provides for the payment to charity of $60x a year for 10 years, the charitable annuity sis subject to prepayment at the discretion of the trustee. The amount of any prepayment is determined on a commuted basis at a date subsequent to the date of transfer. Under these circumstances, the interest does not represent the right to receive periodic payments over a specified period of time because the number of payments will be a function of whether, and to what extent, the trustee decides to prepay the charitable annuity. Similarly, the exact amount payable cannot be determined as of the date of the gift because the amount of each payment will be dependent on whether the trustee decides to prepay.

Therefore, *A*'s transfer to charity is not a guaranteed annuity interest within the meaning of section 2522(c)(2)(B) because the charity does not have the right to receive periodic payments over a specified term and the periodic payments that the charity is entitled to receive are not determinable in amount as of the date of the gift.

HOLDING

If the trustee has the discretion to commute and prepay the charitable "lead" annuity interest prior to the expiration of the specified term of the annuity, the interest does not qualify as a guaranteed annuity interest under section 2522(c)(2)(B) of the Code, and under section 2522(a), no deduction is allowed for the amount of the transfer to charity.

The result would be the same even if the trust instrument provided that the prepayment amount were to be calculated using the discount rate and methodology used to calculate the present value of annuity payments under the Code and regulations in effect on the date the annuity was established, because the exact amount payable to charity can not be determined as of the date of the gift.

Chapter 13.—Tax on Certain Generation-Skipping Transfers
Subchapter A.—Tax Imposed

Section 2601.—Tax Imposed

26 CFR 26.2601-1: Effective dates.

T.D. 8187

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER B, PART 26—GENERATION-SKIPPING TRANSFER TAX REGULATIONS; PART 26a—TEMPORARY GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1976; PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Effective Date Rules and Return Requirements Relating to the Generation-Skipping Transfer Tax

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains amendments to the temporary and final regulations relating to the effective date provisions, return requirements, and certain special rules for the tax on generation-skipping transfers. This action is necessary because of changes to the applicable tax law made by the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2085). These regulations affect all persons making or receiving a generation-skipping transfer. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in *** [page 925, this Bulletin].

DATES: These regulations apply to all generation-skipping transfers made after October 22, 1986.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document provides temporary generation-skipping transfer tax regulations under Chapter 13 of the Internal Revenue Code of 1986 (Code), as added by section 1431 of the Tax Reform Act of 1986 (the Act), concerning the effective date, return requirements, and certain special rules. The temporary regulations provided by this document will remain in effect until superseded by final regulations on this subject. By a separate notice of proposed rulemaking appearing elsewhere in *** [page 925, this Bulletin], the regulations promulgated in this document are also proposed to be prescribed as final generation-skipping transfer tax regulations (26 CFR Part 26) under sections 2601 and 2662.

In General

Chapter 13, as amended by the Act, imposes a flat-rate tax on all noncharitable transfers of property that result in the avoidance of the estate or gift tax in one or more generations below that of the transferor. Certain exceptions to the generation-skipping transfer tax are provided for gifts excluded from tax under sections 2503(b) and (e), transfers covered by the $1,000,000 exemption as defined in section 2631, and direct transfers to grandchildren to the extent that the aggregate amount of such transfers does not exceed $2 million per grandchild ("the grandchild exclusion"). The latter exception applies only to transfers that occur before January 1, 1990. See sections 1433(b)(3) and 1433(d) of the Act and §26.2601-1(d) of these regulations.

Generation-skipping transfers are taxed at the applicable rate as defined in section 2641. This rate is equal to the product of the maximum Federal estate tax rate (55% for 1987-1992) and the inclusion ratio (as defined in section 2642(a)).

These regulations provide rules relating to the effective date provisions in section 1433 of the Act and return requirements. Because Congress is currently considering major technical revisions to Chapter 13, it was considered inappropriate to promulgate rules addressing other areas in the statute. After Congress has concluded its deliberations, substantive regulations, directed at issues where guidance is most needed, will be promulgated. The Internal Revenue Service requests comments identifying these issues. Additional comprehensive regulations will also be published in the future.

Effective Dates

The Chapter 13 tax as enacted in 1976 has been repealed, retroactive to June 11, 1976. Those persons who paid tax under the prior Chapter 13 are entitled to a refund or credit. The time and manner of filing a claim for such refund is provided in §26.2601-1(c)(2)(ii) of these regulations.

Chapter 13 of the Code, as added by the Internal Revenue Code of 1986, generally applies to inter vivos transfers occurring after September 25, 1985, and to all transfers occurring October 22, 1986. The generation-skipping transfer tax does not apply, however, to certain transfers under trusts that were irrevocable on September 25, 1985; transfers occurring under certain wills and revocable trusts executed before October 22, 1986; and certain transfers by a decedent if the decedent was under a mental disability on October 22, 1986. The effective date rules are set forth in section 1433 of the Act and §26.2601-1(b) of these regulations.

Special Rules

A direct skip is a transfer that is subject to estate or gift tax and that is made to a skip person (as defined in section 2613). Section 1433(b)(3) of the Act provides that the term "direct skip" shall not include any transfer before January 1, 1990, from a transferor to a grandchild of the transferor to the extent that the aggregate transfers from such transferor to such grandchild do not exceed $2,000,000 (the "grandchild exclusion").

These regulations do not provide rules for determining when a transfer in trust for the benefit of a grandchild will qualify for the grandchild exclusion because the issue is currently being considered by Congress. However, these regulations do provide guidance regarding the special election provided by section 1433(d) of the Act. That election allows a transferor to elect to treat certain inter vivos and testamentary contingent transfers in trust for the benefit of a grandchild as a direct transfer to the grandchild qualifying the transfers for the grandchild exclusion. The rules for this election are set forth in §26.2601-1(d).

Return Requirements

These regulations specify the time and manner in which a generation-skipping transfer must be reported to the Internal Revenue Service. The due date for a return depends upon the type of event that gives rise to liability for the tax. Generally, the person liable for the tax is required to file the return. In general, in the case of a direct skip (other than a direct skip from a trust), the transferor or the transferor's executor is liable for the tax and must make the return. In the case of a taxable termination or a direct skip from a trust, the trustee is liable for the tax and must make the return. In the case of a taxable distribution, the distributee is liable for the tax and must make the return. However, the regulations also set forth special return requirements for certain direct skips at death under trusts. The return requirement rules are set forth in §26.2662-1.

NEED FOR TEMPORARY REGULATIONS

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue this Treasury Decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

SPECIAL ANALYSES

No general notice of proposed rulemaking is required by 5 U.S.C. §533(b) for temporary regulations. Accordingly, the Regulatory Flexibility Act (5 U.S.C. Chapter 6) does not apply, and no regulatory flexibility analysis is required for this rule. The Commissioner of Internal Revenue has determined that this rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis is therefore not required.

PAPERWORK REDUCTION ACT

The collection of information requirements contained in these regulations have been submitted to the Office of Management and Budget (OMB) for review under the Paperwork Reduction Act of 1980. The requirements have been approved by OMB (control number 1545-0985).

* * * * *

Adoption of amendments to the regulations.

Accordingly, 26 CFR Part 26, Part 26a, and Part 602 are amended as follows:

TEMPORARY GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1976

(26 CFR Part 26a)

Paragraph 1. Part 26a is removed.

GENERATION-SKIPPING TRANSFER TAX REGULATIONS

(26 CFR Part 26)

Par. 2. Part 26 is revised and a new Part 26 is added to read as follows:

Part 26—TEMPORARY GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

§26.2600-1 Table of contents.
§26.2601-1 Effective dates.
§26.2662-1 Generation-skipping transfer tax return requirements.

Part 26—TEMPORARY GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

Authority: 26 U.S.C. 7805. Section 26.2662-1 also issued under 26 U.S.C. 2662.

§26.2600-1 Table of contents.

This section lists the captions that appear in the temporary regulations under sections 2601 and 2662.

§26.2601-1 Effective dates.
- a. Transfers subject to the generation-skipping transfer tax.
  - 1. In general.
  - 2. Certain transfers deemed made after October 22, 1986.
- b. Exceptions.
  - 1. Irrevocable trusts.
    - i. In general.
    - ii. Irrevocable trust defined.
      - A. In general.

B. Property includible in estate under section 2038.
C. Property includible in estate under section 2042.
D. Examples.
iii. Trust containing qualified terminable interest property.
A. In general.
B. Examples.
iv. Additions to irrevocable trusts.
A. In general.
B. Terminations of interests in and distributions from trusts.
C. Allocation fraction.
1. In general.
2. Examples.
v. Constructive additions.
A. In general.
B. Special rule for certain powers of appointment.
C. Constructive addition if liability is not paid out of trust corpus.
D. Examples.
vi. Appreciation and income.
2. Transition rule for wills or revocable trusts executed before October 22, 1986.
i. In general.
ii. Revocable trust defined.
iii. Will or revocable trust containing qualified terminable interest property.
iv. Amendments to will or revocable trust.
v. Additions to revocable trusts.
vi. Examples
3. Transition rule in the case of mental incompetency.
i. In general.
ii. Mental disability defined.
iii. Decedent who has not been adjudged mentally incompetent.
iv. Decedent who has been adjudged mentally incompetent.
v. Rule applies even if another person has power to change trust terms.
4. Exceptions to additions rule.
i. In general.
ii. Examples.
c. Transfers before October 22, 1986.
1. In general.
2. Refunds of overpayments.
i. Waiver of statute of limitations.
ii. Time and manner in which a claim for a credit or refund must be filed.
d. $2,000,000 grandchild exclusion.
1. In general.
2. Treatment of transfers in trust. [RESERVED]
3. Election for certain contingent transfers.
i. In general.
ii. Vesting defined.
iii. Manner of election.
iv. Information to be included in the election.
v. Time for election.
vi. Right of recovery in grandchild's estate.
A. In general.
B. More than one recipient of property.
vii. Examples.
§26.2662-1 Generation-skipping transfer tax return requirements.
a. In general.
b. Form of return.
1. Taxable distributions.
2. Taxable terminations.
3. Direct skip.
i. Inter vivos direct skips.
ii. Direct skips occurring at death.
A. In general.
B. Direct skips payable from a trust.
c. Person liable for tax and required to make return.
1. In general.
2. Special rule for property held in trust arrangements.
i. In general.
ii. Trust arrangement defined.
iii. Executor liable if transfer less than $100,000.
iv. Examples.
3. Limitation on personal liability of trustee.
4. Exceptions.
i. Minors.
ii. Returns made by fiduciaries.
d. Time and manner of filing return.
1. In general.
2. Exceptions.
i. Inter vivos direct skips made after September 25, 1985, and on or before October 22, 1986.
ii. Taxable distributions and taxable terminations occurring after September 25, 1985, and before January 1, 1988.
iii. Direct skips at death.
e. Place for filing returns.
f. Lien on property.

§26.2601-1 Effective dates.

(a) *Transfers subject to the generation-skipping transfer tax*—(1) *In general.* Except as otherwise provided in this section, the provisions of Chapter 13 of the Internal Revenue Code of 1986 (the Code) apply to any generation-skipping transfer, as defined in section 2611, made after October 22, 1986.

(2) *Certain transfers deemed made after October 22, 1986.* For purposes of Chapter 13 and paragraph (a)(1) of this section, any inter vivos transfer that was—

(i) Subject to a tax imposed by Chapter 12, and

(ii) Made after September 25, 1985, and before October 23, 1986, shall be treated as if it were made on October 23, 1986. Where such inter vivos transfer was made to a trust, any subsequent distribution from such trust or termination of an interest in such trust that occurred before October 23, 1986, shall be treated as if the distribution from the trust or termination of interest in the trust occurred immediately after the deemed transfer on October 23, 1986. In the case of multiple transfers to, distributions from, and/or terminations with respect to a trust, all such events shall be treated as if they occurred on October 23, 1986, in the same order as they actually occurred. See paragraph (b)(1)(iv)(B) of this section for rules to determine the portion of such distributions and terminations subject to tax under Chapter 13. This paragraph (a)(2) shall not apply to transfers to trusts covered by the transition rules of paragraphs (b)(2) and (b)(3) of this section.

(b) *Exceptions*—(1) *Irrevocable trusts*—(i) *In general.* The provisions of Chapter 13 will not apply to any generation-skipping transfer under a trust (as defined in section 2652(b)) that was irrevocable on September 25,

1985. The rule of the preceding sentence does not apply to a portion of any generation-skipping transfer under an irrevocable trust where additions are made to the trust after September 25, 1985. See paragraph (b)(1)(iv) of this section for rules to determine the portion of such trust subject to the provisions of Chapter 13.

(ii) *Irrevocable trust defined*—(A) *In general.* Unless otherwise provided in either paragraph (b)(1)(ii)(B) or (b)(1)(ii)(C) of this section, any trust (as defined in section 2652(b)) in existence on September 25, 1985, will be considered an irrevocable trust.

(B) *Property includible in estate under section 2038.* A trust will not be considered an irrevocable trust to the extent that, on September 25, 1985, the settlor held a power with respect to such trust that would have caused the value of the trust to be included in the settlor's gross estate for federal estate tax purposes by reason of section 2038 (without regard to powers relinquished before September 25, 1985) if the settlor had died on September 25, 1985. A trust will be considered subject to a power on September 25, 1985, even though the exercise of the power was subject to the precedent giving of notice, or even though the exercise could take effect only on the expiration of a stated period, whether or not on or before September 25, 1985, notice had been given or the power had been exercised. A trust will not be considered subject to a power if the power is, by its terms, exercisable only on the occurrence of an event or contingency not subject to the settlor's control (other than the death of the settlor) and if the event or contingency had not in fact taken place on September 25, 1985.

(C) *Property includible in estate under section 2042.* A policy of insurance on an individual's life that is treated as a trust under section 2652(b) will not be considered an irrevocable trust to the extent that, on September 25, 1985, the insured possessed any incident of ownership (as defined in §20.2042-1(c)), that would have caused the value of the trust (*i.e.*, the insurance proceeds) to be included in the insured's gross estate for federal estate tax purposes by reason of section 2042, if the insured had died on September 25, 1985.

(D) *Examples.* The following examples illustrate the application of this paragraph (b)(1).

Example (1). On September 25, 1985, S, the settlor of a trust that was created before September 25, 1985, held a testamentary power to add new beneficiaries to the trust. S held no other powers over any portion of the trust. The testamentary power held by S would have caused the trust to be included in S's gross estate under section 2038 if S had died on September 25, 1985. Therefore, the trust is not an irrevocable trust for purposes of this section.

Example (2). On September 25, 1985, W, the wife of the settlor of a trust in existence on that date, had an annual right to withdraw a portion of the corpus of such trust. The trust was otherwise irrevocable on that date. Because the power was not held by the settlor of the trust, it is not a power described in section 2038 of the Code. Thus, the trust is considered an irrevocable trust for purposes of this section.

Example (3). In 1984, A created a trust and retained the right to expand the class of remaindermen to include any of A's afterborn grandchildren. As of September 25, 1985, all of A's grandchildren, were named remaindermen of the trust. Since the exercise of A's power was dependent on there being afterborn grandchildren who were not members of the class of remaindermen, a contingency that did not exist on September 25, 1985, the trust is not considered subject to the power on September 25, 1985, and is an irrevocable trust for purposes of this section. The result is not changed even if grandchildren are born after September 25, 1985, whether or not A exercises his power to expand the class of remaindermen.

Example (4). On September 25, 1985, B purchased an insurance policy on her own life and designated her daughter, D, and granddaughter, GD, as the beneficiaries. B retained the power to obtain from the insurer a loan against the surrender value of the policy. B's insurance policy is a trust (as defined in section 2652(b)) for Chapter 13 purposes. This trust will not be considered an irrevocable trust because, on September 25, 1985, B possessed an incident of ownership that would have caused the value of the policy to be included in B's gross estate under section 2042 if B had died on that date.

Example (5). In 1984, S created a trust naming S's grandchildren as the income and remainder beneficiaries. S retained the power to revoke one-half of the value of the trust at any time prior to S's death. S retained no other powers over the trust corpus. S did not die before September 25, 1985, nor did S exercise or release the power before that date. The half of the trust not subject to S's power to revoke is considered to be irrevocable.

(iii) *Trust containing qualified terminable interest property*—(A) *In general.* For purposes of Chapter 13, a trust described in paragraph (b)(1)(ii) of this section that holds qualified terminable interest property by reason of an election under section 2056(b)(7) or section 2523(f) will be treated in the same manner as if the donor spouse had made an election under section 2652(a)(3). Thus, transfers from such trusts will not be subject to Chapter 13, and the donor spouse will be treated as the transferor of such property. See paragraph (b)(1)(v)(C) of this section for rules concerning the treatment of the trust when estate tax otherwise payable out of property in the trust is not paid out of such property.

(B) *Examples.* The following examples illustrate the application of this paragraph (b)(1)(iii).

Example (1). On March 28, 1985, H established a trust. The trust instrument provided that the trustee must distribute all income annually to H's wife, W, during her life. Upon W's death the remainder is to be distributed to H and W's grandson, GS. H elected under section 2523(f) to treat the property in the trust as qualified terminable interest property. On December 1, 1987, W died and soon thereafter the trust assets were distributed to GS. Because the trust was irrevocable on September 25, 1985, the transfer to GS will not be subject to tax under Chapter 13. H will be treated as the transferor with respect to the transfer of the trust assets to GS in the same manner as if H had made an election under section 2652(a)(3) to reverse the effect of the section 2523(f) election for Chapter 13 purposes.

Example (2). Assume the same facts as in example (1) except that the trust instrument provides that after W's death all income is to be paid annually to H and W's daughter, D. Upon D's death the remainder is to be distributed to GS. D dies on October 1, 1995, and soon thereafter the trust assets are distributed to GS. Because the trust was irrevocable on September 25, 1985, the termination of D's interest is not subject to Chapter 13.

(iv) *Additions to irrevocable trusts*—(A) *In general.* An addition made after September 25, 1985, to an irrevocable trust, which is excluded from Chapter 13 by reason of paragraph (b)(1) of this section, will subject a proportionate amount of distributions from, and terminations of interests in property held in, such trust to the provisions of Chapter 13. When an addition is made, the trust shall be deemed to consist of two portions, a portion not subject to Chapter 13 (the "non-Chapter 13 portion") and a portion subject to Chapter 13 (the "Chapter 13 portion"), each with a separate inclusion ratio (as defined in section 2642(a)). The non-Chapter 13 portion represents the value of the assets of the trust as it existed on September 25, 1985. The applicable fraction (as defined in section 2642(a)(2)) for the non-Chapter 13 portion is deemed to be 1 and the inclusion ratio for such portion is 0. The Chapter 13 portion of the trust represents the value of all additions made to the trust after September 25, 1985. The inclusion ratio for the Chapter 13 portion shall be determined under section 2642. This paragraph requires separate portions of one trust only for purposes of determining inclusion ratios. For purposes of Chapter 13, a constructive addition under paragraph (b)(1)(v) shall be treated as an addition. See paragraph (b)(4) for exceptions to the additions rule of this paragraph (b)(1)(iv).

(B) *Terminations of interests in and distributions from trusts.* Where a termination or distribution described in section 2612 occurs with respect to a trust to which an addition has been made, the portion of such termination or distribution allocable to the Chapter 13 portion is determined by reference to the allocation fraction, as defined in paragraph (b)(1)(iv)(C) of this section. In the case of a termination described in section 2612(a) with respect to a trust, the portion of such termination that is subject to Chapter 13 is the product of the allocation fraction and the value of the trust (to the extent of the terminated interest therein). In the case of a distribution described in section 2612(b) from a trust, the portion of such distribution that is subject to Chapter 13 is the product of the allocation fraction and the value of the property distributed.

(C) *Allocation fraction—(1) In general.* The "allocation fraction" is a fraction that allocates appreciation and accumulated income between the Chapter 13 and non-Chapter 13 portions of a trust. The numerator of the allocation fraction is the amount of the addition (valued as of the date the addition was made) determined without regard to whether or not any part of the transfer is subject to tax under Chapter 11 or Chapter 12. The denominator of the allocation fraction is the total value of the entire trust immediately after the addition. For purposes of this section, the phrase "total value of the entire trust" means the fair market value of the property held in trust (determined under the rules of section 2031) reduced by any amount attributable to the trust that is similar to an amount that would be allowable as a deduction under section 2053. Where there is more than one addition to corpus after September 25, 1985, the portion of the trust subject to Chapter 13 after each such addition will be determined pursuant to a revised fraction. In each case, the numerator of the revised fraction is the sum of—

(*i*) The value of that portion of the trust immediately before the latest addition that, because of prior additions, is subject to Chapter 13, and

(*ii*) The amount of the latest addition. The denominator of the revised fraction is the total value of the entire trust immediately after the addition. If the transfer to the trust is a generation-skipping transfer, the numerator and denominator shall be reduced by the amount of the generation-skipping transfer tax, if any, which is imposed by Chapter 13 on the transfer and actually recovered from the trust. The allocation fraction shall be rounded off to five decimal places (.00001).

(*2*) *Examples.* The following examples illustrate the application of this paragraph (b)(1)(iv).

Example (1). On August 16, 1980, A established an irrevocable trust. Under the trust instrument, the trustee is required to distribute the entire income annually to A's child, C, for life, then to A's grandchild, GC, for life. Upon GC's death, the remainder is to be paid to GC's issue. On October 1, 1986, when the total value of the entire trust was $400,000, A transferred $100,000 to the trust. The allocation fraction is computed as follows:

$$\frac{\text{Value of addition}}{\text{Total value of trust}} = \frac{\$100{,}000}{\$400{,}000 + \$100{,}000} = .2$$

Thus, immediately after the transfer, 20 percent of the value of future generation-skipping transfers under the trust will be subject to Chapter 13.

Example (2). Assume the same facts as in example (1) except that immediately prior to the transfer on October 1, 1986, the fair market value of the individual assets in the trust totaled $400,000. Also assume that the trust had accrued and unpaid debts, expenses, and taxes totaling $300,000. Assume further that the entire $300,000 represented amounts that would be deductible under section 2053 if the trust were includible in a decedent's gross estate. Thus, the numerator of the allocation fraction is $100,000 and the denominator of the allocation fraction is $200,000 [($400,000 − $300,000) + $100,000]. Thus, the allocation fraction is .5 ($100,000/$200,000) and 50 percent of the value of future generation-skipping transfers will be subject to Chapter 13.

Example (3). Assume the same facts as in example (1) except that on January 30, 1988, when the total value of the entire trust is $600,000, A transfers an additional $40,000 to the trust. Before the transfer, the value of the portion of the trust that was attributable to the prior addition was $120,000 [$600,000 × .2]. The new allocation fraction is computed as follows:

$$\frac{\text{Total value of additions}}{\text{Total value of trust}} =$$

$$\frac{\$120{,}000 + \$40{,}000}{\$600{,}000 + \$40{,}000} = \frac{\$160{,}000}{\$640{,}000} = .25$$

Thus, immediately after the transfer, 25 percent of the value of future generation-skipping transfers under the trust will be subject to Chapter 13.

Example (4). Assume the same facts as in example (3) except that on March 1, 1989, when the value of the trust is $800,000, C dies. A generation-skipping transfer occurs at C's death because of the termination of C's life estate. Therefore, $200,000 [$800,000 × .25] is subject to tax under Chapter 13.

(v) *Constructive additions*—(A) *In general.* Except as provided below, where any portion of a trust remains in the trust after the release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise or lapse is treated to any extent as a taxable transfer under Chapter 11 or Chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed will be treated as an addition to the trust. The creator of the power will be considered the transferor of the addition except to the extent that the release, exercise, or lapse of the power is treated as a taxable transfer under Chapter 11 or Chapter 12. In the latter case, the transferor for purposes of Chapter 11 or Chapter 12 is the transferor for purposes of Chapter 13.

(B) *Special rule for certain powers of appointment.* The release, exercise, or lapse of a power of appointment (other than a general power of appointment as defined in section 2041(b)) will not be treated as an addition to a trust if—

(*1*) Such power of appointment was created in an irrevocable trust that is not subject to Chapter 13 under paragraph (b)(1) of this section, and

(*2*) In the case of an exercise, such power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years. If a power is exercised by creating another power it will be deemed to be exercised to whatever extent the second power may be exercised.

(C) *Constructive addition if liability is not paid out of trust corpus.* Where a trust described in paragraph (b)(1) of this section is relieved of any liability properly payable out of the assets of such trust, the person or entity who actually satisfies the liability will be considered to have made a constructive addition to the trust in an amount equal to the liability. The constructive addition occurs when the trust is relieved of liability (*i.e.*, when the right of recovery is no longer enforceable). For example, where an estate fails to exercise the right of recovery available under section 2207A for federal estate tax paid on the value of property includible in the estate under section 2044, the beneficiaries of the estate are considered to have added an amount equal to such federal estate tax attributable to such property to the trust at the time the right of recovery lapses.

(D) *Examples.* The following examples illustrate the application of this paragraph (b)(1)(v).

Example (1). On June 19, 1980, H established an irrevocable trust with a corpus of $500,000. The trust instrument provides that the trustee shall distribute the entire income from the trust annually to H's wife, W, during her life. At W's death the remainder is to be distributed to H and W's grandson, GS. H also gave W a general power of appointment over one-half of the trust assets. On December 21, 1989, when the value of the trust corpus is $1,500,000, W dies without having exercised her general power of appointment. The value of one-half of the trust corpus, $750,000 [$1,500,000 × .5], is included in W's gross estate under section 2041(a) and is subject to tax under Chapter 11. Because the value of one-half of the trust corpus is subject to tax under Chapter 11 with respect to W's estate, W is treated as the transferor of that property for purposes of Chapter 13 (see section 2652(a)(1)(A)). For purposes of the generation-skipping transfer tax, the lapse of W's power of appointment is treated as if $750,000 [$1,500,000 × .5] had been distributed to W and then transferred back to the trust. Thus, W is considered to have added $750,000 0.5 × $1,500,000 at the date of her death. Because this constructive addition occurred after September 25, 1985, 50 percent of the corpus of the trust became subject to Chapter 13 at W's death.

Example (2). Assume the same facts as in example (1) except that on October 1, 1985, when the trust assets were valued at $800,000, H added $200,000 to the trust. After the transfer on October 1, 1985, the allocation fraction was .2 [$200,000/$1,000,000]. On December 21, 1989, when the value of the trust corpus is $1,500,000, W dies without having exercised her general power of appointment. The lapse of W's general power of appointment is treated as if one-half of the corpus has been distributed to W and then transferred by W back to the trust. The value of the property in the trust immediately prior to the constructive addition (*i.e.*, after the deemed distribution to W) would have been $750,000. Thus, after this constructive distribution and constructive addition the new allocation fraction is 0.6 [$900,000/$1,500,000]. The numerator of the fraction is the value of that portion of trust assets that were subject to Chapter 13 immediately prior to the addition (by reason of the first addition) $150,000 [0.2 × $750,000], plus the value of the constructive transfer, $750,000, which equals $900,000. The denominator of the fraction, $1,500,000, is the total value of the trust assets immediately after the transfer. Thus, 60 percent of the corpus of the trust became subject to Chapter 13.

Example (3). On September 25, 1985, B possessed a general power of appointment over the assets of an irrevocable trust that had been created by C in 1980. Under the terms of the trust, B's power lapsed on July 20, 1987. For federal gift tax purposes, B is treated as making a gift of ninety-five percent [100% − 5%] of the value of the corpus (see section 2514). However, because the entire trust was subject to the power of appointment, 100 percent (that portion of the trust subject to the power) of the assets of the trust are treated as a constructive addition. Thus, the entire amount of all generation-skipping transfers occurring pursuant to the trust instrument after July 20, 1987, will be subject to Chapter 13.

Example (4). On March 1, 1985, H established an irrevocable trust as defined in paragraph (b)(1)(ii) of this section. Under the terms of the trust instrument, the trustee is required to distribute the entire income annually to H's son, S, for life, then to H's grandchild, GS, for life. GS has the power to appoint any or all of the trust assets to Trust 2 which is an irrevocable trust (as defined in paragraph (b)(1)(ii) of this section) that was established on August 1, 1985. The terms of Trust 2's governing instrument provide that the trustee shall pay income to H's greatgrandson, GGS, for life. Upon GGS's death the remainder is to be paid to GGS's issue. GGS was alive on March 1, 1985, when Trust 1 was created. S died on April 1, 1986. On July 1, 1987, GS exercised the power of appointment. The exercise of GS's power will not subject future transfers pursuant to Trust 2 to tax under Chapter 13 because exercise of the power in favor of Trust 2 does not suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date of creation of Trust 1, extending beyond any life in being at the date of creation of Trust 1 plus a period of 21 years.

Example (5). Assume the same facts as in example (4) except that GS established Trust 2 on June 1, 1987. The exercise of GS's power will not cause future transfers pursuant to Trust 2's governing instrument to be subject to Chapter 13.

Example (6). Assume the same facts as in example (5) except that GGS was born on March 28, 1986. The exercise of GS's power in favor of Trust 2 will cause the corpus of Trust 1 to be subject to Chapter 13, because GGS was not born until after the creation of Trust 1. Thus, such exercise may suspend the vesting, absolute ownership, or power of alienation of an interest in the trust corpus for a period, measured from the date of creation of Trust 1, extending beyond any life in being at the date of creation of Trust 1 plus a period of 21 years.

(vi) *Appreciation and income.* Except to the extent that the provisions of paragraphs (b)(iv) and (v) of this section allocate subsequent appreciation and accumulated income between the original trust and additions thereto, appreciation in the value of the trust and undistributed income added thereto will not be considered an addition to the corpus of a trust.

(2) *Transition rule for wills or revocable trusts executed before October 22, 1986*—(i) *In general.* The provisions of Chapter 13 will not apply to any generation-skipping transfer under a will or revocable trust executed before October 22, 1986, provided that—

(A) The document in existence on October 21, 1986, was not amended at any time after October 21, 1986, in any respect which results in the creation of, or an increase in the amount of, a generation-skipping transfer,

(B) In the case of a revocable trust, no addition was made to the revocable trust after October 21, 1986, which results in the creation of, or an increase in the amount of, a generation-skipping transfer, and

(C) The decedent died before January 1, 1987.

(ii) *Revocable trust defined.* For purposes of this section, the term "revocable trust" means any trust (as defined in section 2652(b)) except to the extent that, on October 22, 1986, the trust—

(A) Was an irrevocable trust described in paragraph (b)(1) of this section, or

(B) Would have been an irrevocable trust described in paragraph (b)(1) of this section had it not been created or become irrevocable after September 25, 1985, and before October 22, 1986.

(iii) *Will or revocable trust containing qualified terminable interest property.* The rules contained in paragraph (b)(1)(iii) of this section shall apply to any will or revocable trust covered by the transition rule of this paragraph (b)(2).

(iv) *Amendments to will or revocable trust.* For purposes of this section, an amendment to a will or a revocable trust in existence on October 21, 1986, will not be considered to result in the creation of, or an increase in the amount of, a generation-skipping transfer where the amendment is—

(A) Basically administrative or clarifying in nature and only incidentally increases the amount transferred, or

(B) Designed to ensure that an existing bequest or transfer qualifies for the applicable marital or charitable deduction for estate, gift, or generation-skipping transfer tax purposes and only incidentally increases the amount transferred to a skip person.

For purposes of determining whether a particular amendment to a will or revocable trust creates, or increases the amount of, a generation-skipping transfer, the effect of the instrument(s) in existence on October 21, 1986, will be measured against the effect of the instrument(s) in existence on the date of death of the decedent or on the date of any prior generation-skipping transfer. If the effect of an amendment cannot be immediately determined, it will be deemed to create, or increase the amount of, a generation-skipping transfer until a determination can be made.

(v) *Additions to revocable trusts.* Except as provided below, any addition made after October 21, 1986, but before the death of the settlor, to a revocable trust will subject all subsequent generation-skipping transfers under the trust to the provisions of Chapter 13. All additions made to a revocable trust after the death of the settlor (if the settlor dies before January 1, 1987) will be treated as additions to an irrevocable trust. See §26.2601-1(b)(1)(v) for rules involving constructive additions to trusts. See §26.2601-1(b)(1)(v)(B) for rules providing that certain transfers to trusts will not be treated as additions for purposes of this section.

(vi) *Examples.* The following examples illustrate the application of paragraph (b)(2)(iv) of this section. In the following examples, assume that the testator dies on December 31, 1986.

Example (1). On November 1, 1986, A executes a codicil to a will that was in existence on October 21, 1986, removing one of the co-executors named in the will. Although the codicil may have the effect of lowering administrative costs and thus increasing the amount transferred, it will be considered administrative in nature and thus it will not cause generation-skipping transfers under the will to be subject to Chapter 13.

Example (2). On November 1, 1986, B executes a codicil to his will that was in existence on October 21, 1986, revoking a bequest of $100,000 to C, a non-skip person (as defined under section 2613(b)) and causing that amount to be added to a residuary trust containing generation-skipping provisions. Such an amendment will be deemed to increase a generation-skipping transfer and will prevent any transfers under the will from qualifying under paragraph (b)(2)(i) of this section. If, however, C dies before B and under local law the property would have been added to the residue in any event because the bequest would have lapsed, the codicil will not be considered an amendment that increases a generation-skipping transfer.

Example (3). On October 21, 1986, D's will provided that an amount equal to the maximum allowable marital deduction would pass to D's spouse with the residue of the estate passing to a trust established for the benefit of skip persons. On October 23, 1986, the will is amended to provide that the marital share passing to D's spouse shall be the lesser of the maximum allowable marital deduction or the minimum amount which will result in no estate tax liability for D's estate. The amendment may increase the amount of a generation-skipping transfer. Therefore any generation-skipping transfers under the will will be subject to tax under Chapter 13. If it becomes apparent that the amendment did not increase the amount of a generation-skipping transfer, a claim for refund may be filed with respect to any generation-skipping transfer tax that was paid within the period set out in section 6511.

Example (4). On October 21, 1986, C's will provided for the creation upon C's death of two trusts for the benefit of skip persons. On November 1, 1986, C executed a codicil to the will specifically increasing the amount of a generation-skipping transfer under the will. All transfers made pursuant to the will or either of the trusts created thereunder are precluded from qualifying under the transition rule of paragraph (b)(2)(i) of this section and are therefore subject to tax under Chapter 13.

Example (5). Assume that C in example (4) later executed a second codicil deleting the increase to the generation-skipping transfer. Because the provision increasing a generation-skipping transfer did not become effective it will not be considered an amendment to a will in existence on October 22, 1986.

Example (6). Prior to October 22, 1986, S created a trust in which S retained the power to revoke the transfer at any time prior to S's death. The trust provided that upon the death of S the income was to be paid to S's spouse, W, for life and then to S's nephews A, B, and C in equal shares for life, with one-third of the corpus to be distributed per stirpes to each nephew's surviving issue upon the death of the nephew. A became disabled and S modified the trust on December 1, 1986, to increase A's share of the income. Since the amendment did not result in the creation of, or increase in the amount of, a generation-skipping transfer, transfers pursuant to the trust will not be subject to Chapter 13.

Example (7). Assume the same facts as in example (6) except that A, B, and C are skip persons (as defined in section 2613). S's amendment of the trust increasing A's share of the income will subject the trust to the provisions of Chapter 13 because the amendment increases the amount of a generation-skipping transfer.

Example (8). Assume the same facts as in example (7) except that S's amendment of the trust adds S's grandchild, D, as an income beneficiary. The trust will be subject to the provisions of Chapter 13 because this amendment creates a generation-skipping transfer.

Example (9). Assume the same facts as in example (6) except that the amendment adds S's brother, B, as a beneficiary. B's issue are to take a one-fourth share of the corpus per stirpes upon B's death. Because the distribution to be made upon B's death may involve skip persons, the amendment will be considered an amendment that creates or increases a generation-skipping transfer until a determination can be made. Accordingly, all distributions from and terminations of interests in such trust shall be subject to Chapter 13 until it is determined that no skip person has been added to the trust. At that time a claim for refund may be filed within the period set out in section 6511 with respect to any generation-skipping transfer tax that was paid.

(3) *Transition rule in the case of mental incompetency*—(i) *In general.* Where an individual was, on October 22, 1986, under a mental disability to change the disposition of his or her property and did not regain his or her competence to dispose of such property before the date of his or her death, the provisions of Chapter 13 shall not apply to any generation-skipping transfer—

(A) Under a trust (as defined in section 2652(b)) to the extent such trust consists of property, or the proceeds of property, the value of which was included in the gross estate of the individual (other than property transferred by or on behalf the individual during his life after October 22, 1986), or

(B) Which is a direct skip that occurs by reason of the death of the decedent.

(ii) *Mental disability defined.* For purposes of this section, the term "mental disability" means mental incompetence to execute an instrument governing the disposition of the decedent's property, whether or not there was an adjudication of incompetence and whether or not there has been an appointment of a guardian, fiduciary, or other person charged with either the care of the decedent or the care of the decedent's property.

(iii) *Decedent who has not been adjudged mentally incompetent.* If the decedent has not been adjudged mentally incompetent by a court, the executor must file, with Form 706, either—

(A) A certification from a qualified physician stating that the decedent was mentally incompetent at all times on and after October 22, 1986, and did not regain competence to modify or revoke the terms of the trust or will prior to his or her death, or

(B) Sufficient other evidence demonstrating that the decedent was mentally incompetent at all times on and after October 22, 1986, as well as a statement explaining why no certification is available from a physician.

(iv) *Decedent who has been adjudged mentally incompetent.* If the decedent has been adjudged mentally incompetent, a copy of the judgment or decree, and any modification thereof, must be filed with the Form 706.

(v) *Rule applies even if another person has power to change trust terms.* In the case of a transfer from a trust, this paragraph (b)(3) shall apply even though a person charged with the care of the decedent or the decedent's property has the power to revoke or modify the terms of the trust, provided that the power is not exercised after October 22, 1986, in a manner that creates, or increases the amount of, a generation-skipping transfer. See paragraph (b)(2)(iv) of this section for rules concerning amendments that create or increase the amount of a generation-skipping transfer.

(4) *Exceptions to additions rule.* (i) *In general.* Any addition to a trust made pursuant to an instrument or arrangement covered by the transition rules in paragraphs (b)(2) or (b)(3) will not be treated as an addition for purposes of this section. Moreover, any property transferred inter vivos to a trust will not be treated as an addition if the same property would have been added to the trust pursuant to an instrument covered by the transition rules in paragraphs (b)(2) or (b)(3) of this section.

(ii) *Examples.* The following examples illustrate the application of paragraph (b)(4)(i) of this section.

Example (1). On December 31, 1980, A created an irrevocable trust having a corpus of $100,000. Under the terms of the trust, the corpus was to be held for the benefit of A's grandchild, GC. Pursuant to the terms of A's will, a document entitled to relief under the transition rule of paragraph (b)(2) of this section, the residue of the estate was paid to the trust. Because the addition to the trust was paid pursuant to the terms of an instrument (A's will) which was not subject to the provisions of Chapter 13 because of paragraph (b)(2) of this section, the payment to the trust is not considered an addition to the corpus of the trust. Thus, future distributions to or for the benefit of GC, will not be subject to the provisions of Chapter 13.

Example (2). H is the grantor of a trust which was irrevocable on September 25, 1985. H's will, which was executed before October 22, 1986, and not amended thereafter, provides that upon his death the entire estate will pour over into his trust. On October 1, 1985, H transfers $100,000 to the trust. While H's will otherwise qualifies for relief under the transition rule in paragraph (b)(2) of this section, the transition rule is not applicable unless A dies prior to January 1, 1987. Thus, if H dies after December 31, 1986, the transfer will be treated as an addition to the trust for purposes of any distribution made from the trust after the transfer to the trust on October 1, 1985. If H dies before January 1, 1987, the entire trust (as well as any distributions from or terminations of interests in the trust prior to his death) will be excluded, under paragraphs (b)(2) of this section, from Chapter 13 because the $100,000 would have been added to the trust under a will which would have qualified under paragraph (b)(2) of this section. In either case, for any generation-skipping transfers made after the transfer to the trust on October 1, 1985, but before H's death, the $100,000 will be treated as an addition to the trust and a proportionate amount of the trust will be subject to Chapter 13.

Example (3). H and W are the settlors of separate revocable trusts with equal values. Both trusts were established for the benefit of skip persons (as defined in section 2613). W dies on December 1, 1985, and under the provisions of her trust the corpus pours over into H's trust. If H dies before January 1, 1987, the entire trust is excluded under paragraph (b)(2) of this section from the operation of Chapter 13. If H dies after December 31, 1986, the entire trust is subject to the generation-skipping transfer tax provisions because H's trust is not a trust described in paragraph (b)(1) or (b)(2) of this section. In the latter case, the fact that W died before January 1, 1987, is irrelevant because the corpus of her trust was added to a trust that never qualified under the transition rules of paragraph (b)(1) or (b)(2) of this section.

Example (4). Assume the same facts as in example (3) except that upon the death of W on December 1, 1985, her trust continues as an irrevocable trust and that the corpus of H's trust is to be paid over upon his death to W's trust. Again, if H dies before January 1, 1987, W's entire trust falls within the provisions of paragraph (b)(1) of this section. However, if H dies after December 31, 1986, the "pour-over" is considered an addition to the trust. Therefore, W's trust is not a trust excluded under paragraph (b)(2) because an addition is made to the trust.

Example (5). A, the spouse of the settlor of an irrevocable trust that was created in 1980, had, on September 25, 1985, a general power of appointment over the trust assets. The trust provides that should A fail to exercise the power of appointment the property is to remain in the trust. On October 21, 1986, A executed a will under which A failed to exercise the power of appointment. If A dies before January 1, 1987, without having exercised the power in a manner which results in the creation of, or increase in the amount of, a generation-skipping transfer (or amended the will in a manner that results in the creation of, or increase in the amount of, a generation-skipping transfer), transfers pursuant to the trust or the will will not be subject to Chapter 13 because the trust is an irrevocable trust and the will qualifies under paragraph (b)(2) of this section.

Example (6). Assume the same facts as in example (5) except that on October 22, 1986, A did not have a will. Upon A's death, or upon the prior exercise or release of the power, the value of the entire trust will be treated as having been distributed to A, and A will be treated as having made an addition to the trust in the amount of the entire corpus. All subsequent distributions or terminations pursuant to the trust will be subject to Chapter 13. It is immaterial whether A's death occurs before January 1, 1987, since paragraph (b)(2) of this section is only applicable where a will or revocable trust was executed before October 22, 1986.

(c) *Transfers before October 22, 1986*—(1) *In general.* Except as otherwise provided in paragraph (a)(2) of this section, transfers before October 22, 1986, are not subject to generation-skipping transfer tax. In the case of any tax imposed by Chapter 13 of the Internal Revenue Code of 1954 (as in effect on October 31 1986), such tax (including interest, additions to tax, and additional amounts) will not be assessed and if assessed, the assessment will be abated, and if collected, will be credited or refunded (with interest) as an overpayment, upon filing of a claim for credit or refund.

(2) *Refunds of overpayments*—(i) *Waiver of statute of limitations.* Except as provided below, a refund or credit of any payment of tax referred to in paragraph (c)(1) of this section shall be allowed without regard to whether, at any time before October 22, 1987, such refund or credit is barred by law.

(ii) *Time and manner in which a claim for a credit or refund must be filed.* A claim for a refund or credit, that would otherwise be barred by the statute of limitations but for paragraph (c)(2)(i) of this section, must be filed on or before the later of October 22, 1987, or the expiration of the period for filing a claim set out in section 6511 and the regulations thereunder. To claim a refund, Form 843 must be filed in accordance with the instructions thereto.

(d) *$2,000,000 grandchild exclusion*—(1) *In general.* For purposes of this chapter, the term "direct skip" shall not include any transfer before January 1, 1990, from a transferor to a grandchild of the transferor to the extent the aggregate transfers from such transferor to such grandchild do not exceed $2,000,000. For purposes of the preceding sentence, section 2612(c)(2) shall not apply in determining whether an individual is a grandchild of the transferor.

(2) *Treatment of transfers in trust.* [RESERVED]

(3) *Election for certain contingent transfers*—(i) *In general.* A transferor may elect to treat certain transfers in trust for the benefit of the transferor's grandchild as a direct skip to a grandchild thereby qualifying it for the $2,000,000 grandchild exclusion as defined in this paragraph (d). The election is available only to the extent that the transfer occurred before October 22, 1986, and would be a transfer that would qualify for the $2,000,000 grandchild exclusion except for the fact that the trust instrument provides that, if the grandchild dies before vesting of the interest transferred as defined in paragraph (d)(3)(ii) of this section, the interest passes to any person other than the grandchild's estate. This election is available only if during the life of the grandchild, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such grandchild. This election is not available if the trust has more than one grandchild as a beneficiary. If a transferor makes an election under this paragraph (d)(3) with respect to a transfer, such transfer shall be subject to federal estate tax on the grandchild's death in the same manner as if the contingent gift over had been to the grandchild's estate. If all or a portion of a transferor's generation-skipping transfer exemption was previously allocated to property with respect to which a valid election is made under this paragraph (d)(3), such allocation will be deemed to be ineffective without regard to section 2631(b). In addition, if a transferor paid tax imposed by Chapter 13 on the transfer of property with respect to which a valid election is made under this paragraph (d)(3), such transferor may obtain a refund of such tax by filing Form 843 on or before June 13, 1988. The election once maid is irrevocable.

(ii) *Vesting defined.* For purposes of this paragraph (d)(3), an interest in property is vested only if the entire value of the transferred property in which such interest is held will be includible in the grandchild's gross estate for federal estate tax purposes.

(iii) *Manner of election.* The election described in this paragraph (d)(3) is made by attaching a notice of election to a Form 709 filed with the appropriate district office of the Internal Revenue Service within the time set out in paragraph (d)(3)(v) of this section. The notice of election must be signed by both the grandchild (or the grandchild's guardian) and the holders of the contingent gift over (or their authorized representative) and must contain an agreement that:

(A) The property subject to the election or the proceeds thereof, together with any accumulated income therefrom, will be included in the grandchild's estate for federal estate tax purposes even if it is not otherwise includible in such grandchild's estate, and

(B) The estate of the grandchild will have the right of recovery described in paragraph (d)(3)(vi) of this section.

(iv) *Information to be included in the election*—

(A) The notice of election shall also contain the following information:

(*1*) A statement describing the grandchild's right of recovery under paragraph (d)(3)(vi) of this section;

(*2*) The transferor's name and taxpayer identification number as they appear on the generation-skipping transfer tax return;

(*3*) The trust's taxpayer identification number and a copy of the trust instrument;

(*4*) The name, address, and taxpayer identification number of all trust beneficiaries including the holders of the contingent gift over;

(*5*) The transferor's adjusted basis of the transferred property;

(*6*) The date of the transfer;

(*7*) The fair market value of the property at the date of the transfer;

(*8*) A detailed description of the transferred property;

(B) For real estate provide:

(*1*) A legal description of each parcel;

(*2*) The street number, name, and the area if the property is located in a city; and

(*3*) A short statement of improvements made to the property;

(C) For bonds, provide:

(*1*) The number of bonds transferred;

(*2*) The name of obligor;

(*3*) The date of maturity;

(*4*) The rate of interest;

(*5*) The date or dates when interest is payable;

(*6*) The series number if there is more than one issue; and

(*7*) The CUSIP number, if available. The CUSIP number is a nine digit number assigned by the American Banking Association to traded securities.

(D) For stocks provide:

(*1*) The number in shares;

(*2*) The exact name of the corporation;

(*3*) Whether the stock is common or preferred;

(*4*) The issue and par value;

(*5*) The location of the principal business office, the State in which incorporated, and the date of incorporation, if unlisted;

(*6*) The principal exchange where sold, if listed and

(*7*) The CUSIP number, is available. The CUSIP number is a nine digit number assigned by the American Banking Association to traded securities.

For interests in property based on the length of a person's life, provide the date of birth of the person. For life insurance policies, provide the name of the insurer and the policy number.

(v) *Time for election.* The election provided by this paragraph (d)(3) must be made on or before June 13, 1988.

(vi) *Right of recovery in grandchild's estate*—(A) *In general.* The election must contain an agreement granting the grandchild's estate the right to recover the estate tax (including penalties and interest thereon) attributable to the value of property included in the gross estate solely by reason of an election under this paragraph (d)(3) from the person or persons to whom the property is transferred. The amount of estate tax attributable to such property is the amount by which the total tax under Chapter 11 which has been paid, exceeds the total tax under chapter 11 which would have been payable if the value of such property had not been included in the gross estate. Nothing herein should be construed to prohibit the grandchild from directing his executor not to pursue the right to recovery otherwise available under the terms of the agreement.

(B) *More than one recipient of property.* For purposes of this paragraph (d)(3), if there is more than one contingent beneficiary of the property, the agreement may provide that the right of recovery shall apply jointly to all such beneficiaries or it may provide that the estate tax liability be apportioned among such persons according to the relative values of their interests at the time of the inclusion. However, the agreement must provide that the right of recovery shall be against each such contingent beneficiary.

(vii) *Examples.* The following examples illustrate the application of this paragraph (d)(3). Assume in each example that the trust satisfies all requirements for the $2,000,000 grandchild exclusion except as set forth below and that all requirements of the election under this paragraph (d)(3) are satisfied.

Example (1). On September 16, 1986, A established a trust and funded it with $1,000,000. The trust instrument provides that the trust assets shall be transferred to A's grandson, GS, when he attains the age of 30, but if he dies before reaching 30, the assets shall be distributed to GS's heirs. GS is 10 years old at the time of the transfer. The transfer does not qualify for the $2,000,000 grandchild exclusion under paragraph (d)(1) of this section. On April 1, 1987, A elects under this paragraph (d)(3) to treat the transfer as a direct skip to GS. Assuming A's aggregate transfers to GS, up to and including this transfer, do not exceed $2,000,000, the transfer is not subject to tax under Chapter 13.

Example (2). Assume the same facts as in example (1) except that GS dies intestate on March 1, 1988, and GS's mother and father receive the property as GS's heirs. Because of the agreement contained in the notice of election, the property in the trust will be subject to federal estate tax in GS's gross estate in the same manner as if the contingent gift over had been to GS's estate. GS's executor will have a right of recovery against GS's mother and father for the estate taxes attributable to property included in GS's gross estate.

Example (3). Assume the same facts as in example (1) except that the trust instrument provides for payments of income to GS for life, with the remainder to A's greatgrandson, GGS. A is not eligible to make the election under this paragraph (d)(3) because, under the terms of the trust instrument, there is not a contingent gift over.

§26.2662-1 Generation-skipping transfer tax return requirements.

(a) *In general.* Chapter 13 imposes a tax on generation-skipping transfers (as defined in section 2611). The requirements relating to the return of tax depend on the type of generation-skipping transfer involved. This section contains rules for filing the required tax return. Paragraph (c)(2) of this section provides special rules concerning the return requirements for generation-skipping transfers pursuant to certain trust arrangements (as defined in paragraph (c)(2)(ii) of this section) such as life insurance policies and annuities.

(b) *Form of return*—(1) *Taxable distributions.* Form 706GS (D) must be filed in accordance with its instructions for any taxable distribution (as defined in section 2612(b)). The trust involved in a transfer described in the preceding sentence must file Form 706GS(D-1) in accordance with its instruction. A copy of Form 706GS(D-1) shall be sent to each distributee.

(2) *Taxable terminations.* Form 706GS(T) must be filed in accordance with its instructions for any taxable termination (as defined in section 2612).

(3) *Direct skip*—(i) *Inter vivos direct skips.* Form 709 must be filed in accordance with its instructions for any direct skip that is subject to a tax imposed by Chapter 12 and occurs during the life of the transferor.

(ii) *Direct skips occurring at death*—(A) *In general.* Form 706 must be filed in accordance with its instructions for any direct skips that are subject to a tax imposed by Chapter 11 and occur at the death of the decedent.

(B) *Direct skips payable from a trust.* Schedule R-1 of Form 706 must be filed in accordance with its instructions for any direct skip from a trust if such direct skip is subject to a tax imposed by Chapter 11. See paragraph (c)(2) of this section for special rules relating to the person liable for tax and required to make the return under certain circumstances.

(c) *Person liable for tax and required to make return*—(1) *In general.* Except as otherwise provided in this section, the following person is liable for the tax imposed by section 2601 and must make the required tax return—

(i) The transferee in a taxable distribution (as defined in section 2612(b)),

(ii) The trustee in the case of a taxable termination (as defined in section 2612(a)),

(iii) The transferor (as defined in section 2652(a)(1)(B)) in the case of an inter vivos direct skip (as defined in section 2612(c)),

(iv) The trustee in the case of a direct skip from a trust or with respect to property that continues to be held in trust, or

(v) The executor in the case of a direct skip (other than a direct skip described in paragraph (c)(1)(iv) of this section) if the transfer is subject to a tax imposed by Chapter 11. See paragraph (c)(2) of this section for special rules relating to direct skips to or from certain trust arrangements (as defined in paragraph (c)(2)(ii) of this section).

(2) *Special rule for direct skips occurring at death with respect to property held in trust arrangements*—(i) *In general.* In the case of certain property held in a trust arrangement (as defined in paragraph (c)(2)(ii) of this section) at the transferor's date of death, the person who is required to make the return and who is liable for the tax imposed by Chapter 13 is determined under paragraph (c)(2)(iii) of this section.

(ii) *Trust arrangement defined.* For purposes of this §26.2662-1, the term "trust arrangement" includes any arrangement (other than an estate) which, although not an explicit trust, has the same effect as an explicit trust. For purposes of this §26.2662-1, the term "explicit trust" means a trust described in §301.7701-4(a).

(iii) *Executor liable if transfer less than $100,000.* In any case of a direct skip occurring at death, the executor of the decedent's estate shall be liable for the tax imposed on that direct skip by Chapter 13 and is required to file Form 706 (and not Schedule R-1 of Form 706) if, at the date of the decedent's death,—

(A) The property involved in the direct skip is held in a trust arrangement, and

(B) The total value of the property involved in direct skips with respect to the trustee of that trust arrangement is less than $100,000.

In cases where the rule of this paragraph (c)(2)(iii) imposes liability for the generation-skipping transfer tax on the executor, the executor shall be entitled to recover, from the trustee (if the property continues to be held in trust) or from the recipient of the property (in the case of a transfer from a trust), the generation-skipping transfer tax attributable to the transfer.

(iv) *Examples.* The following examples illustrate the application of this paragraph (c)(2).

Example (1). On August 1, 1988, A, the insured under an insurance policy, died. The proceeds ($95,000) were includible in A's gross estate for federal estate tax purposes. A's grandchild GC, was named the sole beneficiary of the policy. The insurance policy is treated as a trust under section 2652(b)(1), and the payment of the proceeds to GS is a transfer "from a trust" for purposes of Chapter 13. Therefore, the payment of the proceeds to GS is a direct skip. Since the proceeds from the policy ($95,000) are less than $100,000, the executor is liable for the tax imposed by Chapter 13 and is required to file Form 706.

Example (2). Assume the same facts as in example (1) except that A is the insured under two insurance policies issued by the same insurance company. The proceeds ($75,000) from each policy were includible in A's gross estate for federal estate tax purposes. A's grandson, GS, was named the sole beneficiary of Policy 1 and A's granddaughter, GD was named the sole beneficiary of Policy 2. GS and GD are skip persons (as defined in section 2613). Therefore, the payments of the proceeds are direct skips. Since the total value of the policies ($150,000) exceeds $100,000, the insurance company is liable for the tax imposed by Chapter 13 and is required to file Schedule R-1 of Form 706.

Example (3). On August 1, 1988, A, the insured under an insurance policy, dies. The policy provides that the insurance company shall make monthly payments of $750 to GC, A's grandchild, for life with the remainder payable to A's greatgrandchild, GGC. The face value of the policy is $110,000. Since the proceeds will continue to be held by the insurance company (the trustee), the proceeds are treated as if they were transferred to a trust for purposes of Chapter 13. The trust is a skip person (as defined in section 2613(a)(2)) and the transfer is a direct skip. Since the total value of the policy ($110,000) exceeds $100,000, the insurance company is liable for the tax imposed by Chapter 13 and is required to file Schedule R-1 of Form 706.

Example (4). Assume the same facts as in example (3) except that the policy provides that the insurance company shall make monthly payments of $500 to GC and that the face value of the policy is $95,000. The transfer is a transfer to a trust for purposes of Chapter 13. However, since the total value of the policy ($95,000) is less than $100,000, the executor is liable for the tax imposed by Chapter 13 and is required to file Form 706.

(3) *Limitation on personal liability of trustee.* A trustee shall not be personally liable for any increases in the tax imposed by section 2601 which is attributable to the fact that—

(i) A transfer was made to the trust during the life of the transferor for which a gift tax return was not filed, or

(ii) The inclusion ratio with respect to the trust, determined by reference to the transferor's gift tax return, is erroneous, the actual inclusion ratio being greater.

This paragraph (c)(3) shall not apply if the trustee has or is deemed to have knowledge of facts sufficient to reasonably conclude that a gift tax return was required to be filed or that the inclusion ratio was erroneous. A trustee will be deemed to have knowledge of such facts if the trustee's agent, employee, partner, or co-trustee has knowledge of such facts.

(4) *Exceptions*—(i) *Minors.* Where a distributee who is a minor is otherwise required to make a return, the return may be made for the minor by the minor's guardian or, if no guardian has been appointed, by a person charged with the care of the minor's person or property.

(ii) *Returns made by fiduciaries.* See section 6012(b) and the regulations thereunder for a fiduciary's responsibilities regarding the returns of decedents, returns of persons under a disability, returns of estates and trusts, and returns made by joint fiduciaries.

(d) *Time and manner of filing return*—(1) *In general.* Forms 706, 706GS(D), 706GS(D-1), 706GS(T), 709, and Schedule R-1 of Form 706 must be filed with the Internal Revenue Service office with which an estate or gift tax return of the transferor must be filed. The return shall be filed—

(i) In the case of a direct skip, on or before the date on which an estate or gift tax return is required to be filed with respect to the transfer (see section 6075(b)(3)), and

(ii) In all other cases, on or before the 15th day of the 4th month after the close of the calendar year in which such transfer occurs.

(2) *Exceptions*—(i) *Inter vivos direct skips made after September 25, 1985, and on or before October 22, 1986.* The return with respect to the tax imposed by Chapter 13 on any inter vivos direct skip after September 25, 1985, and on or before October 22, 1986, must be filed on or before June 13, 1988.

(ii) *Taxable distributions and taxable terminations occurring after September 25, 1985, and before January 1, 1988.* If the person liable for the tax under this chapter is required to file Form 706GS(T) or 706GS(D), with respect to a transfer which occurred after September 25, 1985, and before January 1, 1988, the return shall be filed on or before a date to be specified in an announcement that will appear in the Internal Revenue Bulletin.

(iii) *Direct skips at death.* The due date for any return with respect to the tax imposed by Chapter 13 on any direct skip attributable to the death of the decedent shall be no earlier than June 13, 1988.

(e) *Place for filing returns.* See section 6091 and the regulations thereunder for the place for filing any return, declaration, statement, or other document, or copies thereof, required by this chapter.

(f) *Lien on property.* The liens imposed under sections 6324, 6324A, and 6324B are applicable with respect to the tax imposed under Chapter 13. Thus, a lien under 6324 is imposed in the amount of the tax imposed by section 2601 on all property transferred in a generation-skipping transfer until the tax is fully paid or becomes uncollectible by reason of lapse of time. The lien attaches at the time of the generation-skipping transfer and is in addition to the lien for taxes under section 6321.

OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

(26 CFR Part 602)

Par. 3. The authority citation for Part 602 continues to read as follows:

Authority 26 U.S.C. 7805.

Par. 4. Section 602.101(c) is amended by inserting in the appropriate places in the table "§26.2601-1 . . . 1545-0985" and "§26.2662-1 . . .1545-0985".

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved February 24, 1988.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on March 14, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 15, 1988, 53 F.R. 8441; and corrected 53 F.R. 18839)

Subtitle C.—Employment Taxes
Chapter 21.—Federal Insurance
Contribution Act
Subchapter C.—General Provisions

Section 3121.—Definitions

FICA, hospital insurance; state and political subdivision employees. Guidance is provided, in question and answer form, concerning the application of the hospital insurance (medicare) tax portion of the Federal Insurance Contributions Act (FICA) by section 3121(u) of the Code, to wages for services performed by state and political subdivision employees hired after March 31, 1986. Rev. Rul. 86-88 supplemented.

Rev. Rul. 88-36

This revenue ruling supplements Rev. Rul. 86-88, 1986-2 C.B. 172, which provides guidelines, in question and answer form, concerning the 1985 amendment of section 3121(u) of the Internal Revenue Code. In general, the amendment extends the hospital insurance (medicare) tax portion of the Federal Insurance Contributions Act (FICA) to wages for services rendered by state and political subdivision employees hired after March 31, 1986.

In this revenue ruling, the terms "state," "political subdivision," "state employer," "political subdivision employer," and "continuing employment exception" have the same meanings as in Rev. Rul. 86-88.

Services Subject to the Medicare Tax

Q1. If an individual receiving social security retirement insurance benefits was hired as an employee of a state or political subdivision after March 31, 1986, are the services performed by the individual for the state or political subdivision subject to the medicare tax?

A1. Yes. The fact that an employee is receiving social security retirement insurance benefits does not affect the employee's liability for the medicare tax.

Q2. Are services performed by an election official or election worker for a state employer or political subdivision employer subject to the medicare tax?

A2. Yes, unless the remuneration paid in a calendar year for such service is less than $100. Section 3121(u)(2)(B)(ii)(V) of the Code, added by section 1895(b)(18)(A) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 852. This amendment is effective for services rendered after March 31, 1986.

Q3. A township has a small number of regularly employed fire fighters. To assist these fire fighters, certain residents of the township have volunteered their services in cases of emergency. The township alerts these residents to emergencies by sounding a siren. The township keeps a record of the residents who respond to the emergency calls and periodically pays each such resident a nominal amount for each emergency for which the resident performed services. Are the payments made to the residents by the township subject to the medicare tax?

A3. No. The services are considered to be performed by an employee of a state or political subdivision on a temporary basis in case of fire, storm, snow, earthquake, flood, or other similar emergency and thus are not subject to the medicare tax. *See* Section 3121(u)(2)(B)(ii)(III) of the Code.

The Continuing Employment Exception

Q4. An individual was hired in September 1984 as a part-time cook by a state hospital to perform two hours of paid service each Sunday preparing the evening meal. The individual is not a patient or inmate of the hospital and has worked two hours each week as an employee of the hospital continuously since September 1984. Are the individual's services performed after March 31, 1986, subject to the medicare tax?

A4. No. The continuing employment exception applies here if the individual was performing regular and substantial services for remuneration for the state employer or political subdivision employer before April 1, 1986. Whether this requirement is met is a question of fact. On these facts, the individual's services are determined to be regular and substantial, and the exception applies.

Q5. In November 1982, an individual was elected to a state public office for a four-year term beginning in January 1983, making the individual an employee of the state. In November 1986, the individual was re-elected. Are the individual's services performed in the second term that begins in January 1987 subject to the medicare tax?

A5. No. The continuing employment exception applies here if the employment relationship has not been terminated after March 31, 1986. The individual was re-elected before the first term expired, so there was no break in the employment relationship.

Q6. *B*, a school district employee, performed regular and substantial services for remuneration for a political subdivision employer during the school year beginning in September 1985 and ending in May 1986. In May 1986, the school district notified *B* that *B*'s employment would be terminated as of the end of May 1986 because the school district might not receive sufficient funding. *B* continued to be covered under the school district's health insurance program through August 1986 on the same basis as before May 1986. Sufficient funding was provided, and in September 1986 *B* began working on the same basis as before. Are *B's* services performed after August 31, 1986, subject to the medicare tax?

A6. No. In Fact, *B*'s employment with the school district was continuous because the school district received sufficient funding. The school district's personnel policies indicate that the employment relationship continued because *B* retained health insurance coverage. *See* Q&A6 of Rev. Rul. 86-88.

Q7. *C*, a professor at a state university, performed regular and substantial services for remuneration for the university from September 1985 to June 1986. *C* was granted a leave of absence for the 1986-1987 school year, with the right to return to the same position at the end of the leave. In September 1987, *C* returned from the leave and resumed the same position with the university. Are *C*'s services performed after returning from the leave of absence subject to the medicare tax?

A7. No. The leave of absence was granted by the university and did not terminate the employment relationship. The university's peronnel policies indicate that the employment relationship continued because *C* was given the right to return to the same position. See Q&A6 of Rev. Rul. 86-88.

Q8. *D* taught a two-hour photography course twice a week at a local community college in the spring semester, which began on March 1, 1986. *D* then signed a three-year agreement with the college that he would teach the same course every spring. When *D* returned in the spring of 1987, were his services subject to the medicare tax?

A8. No. *D* was performing regular and substantial services for remuneration prior to April 1, 1986. The employment relationship was not terminated, as *D* had a commitment to return to the same position each spring.

Q9. Each summer, a Township Parks Department advertises for workers to cut grass. *E* was hired by the township in May 1985 to cut grass during that summer. *E* stopped performing services for the township at the end of that summer. In May 1986, *E* was again hired by the township to cut grass. Are *E's* services performed when *E* returned in May 1986 subject to the medicare tax?

A9. Yes. *E*'s employment relationship was terminated after April 1, 1986, as *E* had no commitment to perform services for the township each summer.

Q10. A part-time police officer has been paid on a weekly basis since March 10, 1986, to be "on call" for a set schedule of hours each week. When the officer is "on call," he must stay at his residence and be available to provide assistance in the case of an emergency or to handle any police business that may arise. Are the services performed by the officer after April 1, 1986 subject to the medicare tax?

A10. No. Although the officer responds to calls on an "as needed" basis, he has a set schedule of hours during which he is performing the service of being available to respond to such calls. Based on the above facts, the officer was performing regular and substantial services for remuneration prior to April 1, 1986 and thus, qualifies for the continuing employment exception to the medicare tax.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 86-88, 1986-2 C.B. 172, is supplemented.

Chapter 22.—Railroad Retirement Tax Act
Subchapter C.—Tax on Employers

Section 3221.—Rate of Tax

Determination of Quarterly Rate of Excise Tax for Railroad Retirement Supplemental Annuity Program

In accordance with directions in section 3221(c) of the Railroad Retirement Act (26 U.S.C., section 3221(c)), the Railroad Retirement Board has determined that the excise tax imposed by such section 3221(c) on every employer, with respect to having individuals in his employ, for each work-hour for which compensation is paid by such employer for services rendered to him during the quarter beginning April 1, 1988, shall be at the rate of 26 cents.

In accordance with directions in section 15(a) of the Railroad Retirement Act of 1974, the Railroad Retirement Board has determined that for the quarter beginning April 1, 1988, 29.9 percent of the taxes collected under sections 3211(b) and 3211(c) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Account and 70.1 percent of the taxes collected under such sections 3221(b) and 3221(c) plus one hundred percent of the taxes collected under section 3221(d) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Supplemental Account.

By Authority of the Board.

Beatrice Ezerski,
Secretary of the Board.

Dated: February 19, 1988.

(Filed by the Office of the Federal Register on February 24, 1988, 8:45 a.m., and published in the issue of the Federal Register for February 25, 1988, 53 F.R. 5668)

Chapter 24.—Collection of Income Tax at Source on Wages
Subchapter A.—Withholding from Wages

Section 3406.—Backup Withholding

26 CFR 35a.9999-2: Questions and answers concerning due diligence and issues in connection with backup withholding.

Rental assistance payments made by public housing agencies to owners of authorized housing projects are subject to information reporting under section 6041 of the Code. See Rev. Rul. 88-53, page 384.

Subtitle D.—Miscellaneous Excise Taxes
Chapter 31.—Retail Excise Taxes
Subchapter A.—Special Fuels

Section 4041.—Imposition of Tax

26 CFR 48.4041-21T: Election to have certain diesel fuel taxes imposed on sales to retailers.

T.D. 8181

TITLE 26—INTERNAL REVENUE.—CHAPTER 31, SUBCHAPTER A, PART 48—MANUFACTURERS AND RETAILERS EXCISE TAXES; PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Election to Have Certain Diesel Fuel Taxes Imposed on Sales to Retailers

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the collection of excise taxes on diesel fuel under an election provided by section 4041(n) of the Code. Changes to the law relating to diesel fuel were made by the Tax Reform Act of 1986. These regulations provide guidance to taxpayers who are subject to these laws. This document does not reflect changes to the diesel fuel excise tax that were made by the Revenue Act of 1987.

EFFECTIVE DATES: The regulations are effective and apply to sales of diesel fuel for use in diesel-powered highway vehicles made after March 31, 1987, and before April 1, 1988, with the exception of the following provisions, which are effective as of March 1, 1988:

§48.4041-21T(g);

§48.4041-21T(h)(1) following "section 4041(a)(1),";

§48.4041-21T(h)(2);

§48.4041-21T(i)(3); and

§48.4041-21T(k)(1).

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains amendments to the Manufacturers and Retailers Excise Tax Regulations (26 CFR Part 48) under section 4041 of the Internal Revenue Code of 1986 (Code). These regulations conform the regulations to section 1702 of the Tax Reform Act of 1986 [Pub. L. 99-514, 100 Stat. 2773], which added section 4041(n) to the Code. These regulations do not reflect changes made to the diesel fuel excise tax by the Revenue Act of 1987 (Pub. L. 100-203, 101 Stat. 1330).

IN GENERAL

Under section 4041(a)(1) of the Code, excise taxes are imposed on the sale of any liquid sold for use as fuel in a diesel-powered highway vehicle. The taxes are imposed when the liquid is sold to an owner, lessee, or other operator of a diesel powered highway vehicle for use as fuel in such vehicle.

Because there are many more retail outlets for diesel fuel sales than there are diesel fuel wholesalers, Congress determined that the number of taxpayers required to file returns for the diesel fuel tax would be reduced if a mechanism was provided to impose the tax at the time of sale to the retailer. Such a mechanism would reduce the tax administrative burden to taxpayers and the tax enforcement cost to the Internal Revenue Service.

Accordingly, the Tax Reform Act added section 4041(n) to the Code. Under this provision, a qualified diesel fuel retailer may elect to shift the liability for the tax imposed by section 4041(a)(1) to the seller of the fuel to that retailer. A qualified retailer is not required to make the election with respect to all its sellers in order for the election to become effective. The qualified retailer remains liable, however, for any tax imposed on the subsequent sale of diesel fuel purchased tax-free from a seller not covered by a valid election.

Making the election

To make the election as to a particular seller, a qualified retailer must notify the seller in writing and obtain the seller's written consent to liability for the tax. The qualified retailer must then file Form 8587 with the District Director for the district in which the retailer's principal place of business is located, attaching a copy of the seller's consent. If the District Director approves the seller and determines that all the requirements for making the election have been met, the District Director will validate the election and notify the qualified retailer and the seller in writing.

Effect of a valid election

Once a qualified retailer has made a valid election with respect to a particular seller under this provision, the qualified retailer must buy all diesel fuel from that seller tax-paid. However, a liquid will not be treated as taxable diesel fuel and the seller will not be liable for the tax if the qualified retailer certifies in writing that the liquid will not be sold for use as fuel in a diesel-powered highway vehicle. This exception is discussed in greater detail below. In addition, a qualified retailer may add a new seller at any time by making a supplemental election as to that seller under the same rules as for making an initial election, as set forth above.

Revocation of the election

A qualified retailer may revoke a valid election with respect to a particular seller at any time by submitting a written statement of revocation to the District Director. A revocation made by a qualified retailer is effective as of the date specified by the District Director in a written notice sent to the qualified retailer and the seller as to whom the revocation is made. If the retailer subsequently makes another election as to that seller under section 4041(n) of the Code, the new election cannot become effective before the beginning of the fourth full calendar quarter following the effective date of the revocation. The District Director may also revoke a qualified retailer's election by sending a written notice of revocation to the qualified retailer and each of the affected sellers if the District Director determines that such action is necessary to protect the revenue. A revocation made by the District Director takes effect on the date specified in the written notice of revocation. A new election made under section 4041(n) following a revocation by the District Director cannot become effective before the beginning of the revocation.

Revocation of Seller's Consent

A seller may revoke consent to liability for the tax imposed on the sale of diesel fuel to a qualified retailer by submitting a written statement of revocation to the District Director. A revocation of consent is effective as of the date specified by the District Director in a written notice sent to the seller and the qualified retailer.

Penalty for failing to notify

If a qualified retailer fails to notify a seller of the election in writing, all diesel fuel purchased from that seller is treated as if sold by the qualified retailer in a sale of diesel fuel taxable under section 4041(a)(1) of the Code on the date the qualified retailer purchased it. The qualified retailer must also pay a penalty pursuant to section 6652(j)[k] equal to 5% of any tax imposed on the sale under section 4041(a)(1). In addition, the qualified retailer's election under this section is subject to revocation by the District Director if the District Director determines such action is necessary to protect the revenue.

Requirements for approval of a seller

In order to be approved under a qualified retailer's election, a seller of diesel fuel must fulfill certain requirements. The proposed regulations require that the seller: (a) be in the trade or business of selling diesel fuel for resale by a retailer; (b) hold a valid Federal Employer's Identification Number; (c) have a regular, physical place of business in the state or territory in which its principal place of business is located; and (d) have complied with all local laws regarding the sale of diesel fuel in each jurisdiction in which it sells diesel fuel. The District Director may withhold or revoke approval of the seller if the seller does not fulfill these requirements, or if the District Director determines that such action is necessary to protect the revenue.

Liquid Certified for Use as Other Than Diesel Fuel

Liquid otherwise taxable under section 4041(a)(1) of the Code is not treated as diesel fuel for the purposes of an election made under section 4041(n) if the qualified retailer certifies in writing to the seller that the liquid will not be sold for use as fuel in a diesel-powered highway vehicle. If the liquid is actually used as diesel fuel, however, or if the qualified retailer cannot establish, upon request of the District Director, that the liquid was used for a purpose other than as diesel fuel, the qualified retailer, and not the seller, is liable for all taxes which would have been imposed on the sale if it had not been certified as nontaxable.

SPECIAL ANALYSIS

A general notice of proposed rulemaking is not required by 5 U.S.C. 553(b) for temporary regulations. Accordingly, the Regulatory Flexibility Act (5 U.S.C. Chapter 6) does not apply and no Regulatory Flexibility Analysis is required for this rule. The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291, and that Regulatory Impact Analysis is therefore not required.

PAPERWORK REDUCTION ACT

The collection of information requirements contained herein have been submitted to the Office of Management and Budget (OMB) for review under section 3504(h) of the Paperwork Reduction Act. These requirements have been approved by OMB under control number 1545-0977.

* * * * *

Adoption of amendments to the regulations

Accordingly 26 CFR Part 48 is amended as follows:

Paragraph 1. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Paragraph 2. In §602.101(c), the table of OMB control numbers is amended by adding in the appropriate location, "48.4041-21T . . . 1545-0977."

Paragraph 3. The authority for Part 48 is amended by adding the following citation:

Authority: 26 U.S.C. 7805 *** Section 48.4041-21T is also issued under 26 U.S.C. 4041(n).

Paragraph 4. A new §48.4041-21T is added after §48.4041-20 to read as follows:

§48.4041-21T Election to have certain diesel fuel taxes imposed on sales to retailers.

(a) *Outline of provisions.* The provisions of this section are as follows:

- (b) In general.
- (c) Definitions.
  - (1) Qualified retailer.
  - (2) Retailer.
  - (3) Seller.
- (d) Manner of election.
  - (1) Procedure for making election.
    - (i) Filing requirements.
    - (ii) Acknowledgement by the District Director.
  - (2) Approval of a seller by the District Director.
    - (i) In general.
    - (ii) Authority to withhold or revoke approval.
      - (A) In general.
      - (B) Notification of approval withheld or revoked.
  - (3) Adding a new seller.
  - (4) Validation of election.
- (e) Failure to make election.
- (f) Penalty for failure to provide notice.
  - (1) In general.
  - (2) Presumption where written consent received.
- (g) Retailer's notice to seller.
- (h) Seller's consent to liability.
  - (1) In general.
  - (2) Form of consent.
- (i) Liquid that is not treated as diesel fuel.
  - (1) In general.
  - (2) Liabiilty for violation of certification.
  - (3) Acceptable form of certification.
- (j) Exemptions not to apply.
- (k) Revocation of election.
  - (1) By qualified retailer.
    - (i) In general.
    - (ii) Effective date of a new election following a voluntary revocation.
    - (iii) Acceptable form for revocation.
  - (2) Revocation by the District Director.
    - (i) In general.
    - (ii) Making a new election following revocation by the District Director.
- (l) Revocation of seller's consent to liability.
- (m) Recordkeeping requirements.
  - (1) Qualified retailer.
  - (2) Seller.

(b) *In general.* A retailer of diesel fuel may elect, with a seller's written consent, to have the excise tax imposed by section 4041(a)(1) on all sales of fuel for use in diesel-powered highway vehicles imposed on such seller at the time of sale to the retailer. A retailer who has made a valid election under paragraph (d) of this section is considered a qualified retailer (as defined in paragraph (c)(1) of this section), and may purchase diesel fuel tax-paid from any seller approved by the District Director under the qualified retailer's election. An approved seller is liable for any tax imposed on a sale of diesel fuel to the qualified retailer by section 4041(a)(1) at the time of sale, except as provided in paragraph (i) of this section. Once a qualified retailer has made a valid election with respect to one or more approved sellers, tax-free purchases of diesel fuel may be made under paragraph (e) of this section only from a person not approved as a seller under a valid election. This election is available for sales made to a qualified retailer after March 31, 1987. See paragraph (c) of this section for definitions of "qualified retailer" and "seller". See paragraph (d)(2) of this section for rules relating to approval of a seller by the District Director.

(c) *Definitions*—(1) *Qualified retailer.* For purposes of this section, a "qualified retailer" is any retailer who—

(i) Makes a valid election under paragraph (d)(1) of this section to have section 4041(n)(1) apply to all sales of diesel fuel to such retailer by any seller approved by the District Director under paragraph (d)(2) of this section, and

(ii) Agrees to provide a written notice, as described in paragraph (d)(1)(i)(A) of this section, to each seller with respect to whom the election is made that section 4041(n)(1) applies to all sales of diesel fuel to such retailer by any seller approved by the District Director under paragraph (d)(2) of this section.

(2) *Retailer.* For purposes of this section, a retailer is any person who sells diesel fuel for use as a fuel in a diesel-powered highway vehicle. Such term does not include a person who sells diesel fuel primarily for resale.

(3) *Seller.* A seller is any person

who sells diesel fuel to a retailer.

(d) *Manner of election*—(1) *Procedure for making election*—(i) *Filing requirements.* To make the election, a qualified retailer must, prior to purchasing diesel fuel under the terms of this section, agree to have the tax imposed by section 4041(a)(1) apply to all sales of diesel fuel to the retailer by any seller approved by the District Director under paragraph (d)(2) of this section by—

(A) Providing the seller with a written notice (as described in paragraph (g) of this section) that the retailer is making the election and that, once validated by the District Director,

(*1*) The election applies to all sales of diesel fuel to such retailer by a seller approved by the District Director under paragraph (d)(2) of this section; and

(*2*) The retailer may not purchase diesel fuel tax-paid from any person that is not an approved seller;

(B) Obtaining a written consent to liability (as described in paragraph (h) of this section) from the seller for the tax imposed by section 4041(a)(1) on the sale of diesel fuel to the qualified retailer; and

(C) Filing Form 8587, Election by Qualified Diesel Fuel Retailer, with the District Director for the district in which the qualified retailer's principal place of business is located, together with a copy of the written consent to liability received from each seller listed on the Form 8587 filed.

(ii) *Acknowledgement by the District Director.* The District Director shall send a written acknowledgement of receipt to the retailer upon receiving the retailer's Form 8587 and all consents attached thereto.

(2) *Approval of a seller by the District Director*—(i) *In general.* In order to participate under a qualified retailer's election, a seller must be approved by the District Director for the district in which the qualified retailer's principal place of business is located. Before approving a seller, the District Director must first receive a copy of the seller's written consent to liability (as described in paragraph (h) of this section) for the tax imposed by section 4041(a)(1) on the sale of diesel fuel to the qualified retailer.

(ii) *Authority to withhold or revoke approval*—(A) *In general.* The District Director may withhold or revoke approval of a seller under a qualified retailer's election if the seller does not fulfill the requirements of paragraph (h) of this section, or if the District Director determines that such action is necessary to protect the revenue. In making this determination, the District Director may consider the tax compliance record of the seller or of a person related to the seller within the meaning of section 267(b) or section 707(b)(1). For example, a District Director may withhold or revoke approval of a seller if the seller or a person related to the seller—

(*1*) Has had a penalty assessed against such person under chapter 68 of the Internal Revenue Code; or

(*2*) Has been convicted of a crime under chapter 75 of the Internal Revenue Code.

(B) *Notification of approval withheld or revoked.* If the District Director withholds approval of a seller listed on a retailer's Form 8587, the District Director shall so notify the retailer and the seller for whom approval is withheld. Such notification may be made either orally or in writing. The retailer may then either amend the Form 8587 to delete that seller's name from the list of sellers appearing therein, or the retailer may withdraw the election application entirely. If the District Director revokes approval of a seller under the rules of paragraph (d)(2)(ii)(A) of this section, the District Director shall notify such seller and each qualified retailer under whose election the seller had been approved in writing immediately following such revocation. A revocation of a seller's approval under paragraph (d)(2)(ii)(A) takes effect on the date specified by the District Director in the written notice. A notice of revocation sent to a qualified retailer under this paragraph (d)(2)(ii)(B) shall be limited to informing the qualified retailer of the fact and date of revocation. A notice of revocation sent to a seller under this paragraph (d)(2)(ii)(B) must include a statement of the reason for the revocation.

(3) *Adding a new seller.* A qualified retailer may make an election under this section with respect to a new seller at any time. See, however, paragraph (e) of this section for rules governing sales of diesel fuel to a qualified retailer from a person not approved as a seller under a valid election.

(4) *Validation of election.* The District Director shall validate an election with respect to a seller listed on the retailer's Form 8587 when the District Director determines that the requirements of this section have been met and approves the seller under paragraph (d)(2) of this section. If the election is validated with respect to a particular seller, the District Director shall notify the qualified retailer and the approved seller in writing that the election is valid, and that the seller is liable for the tax imposed by section 4041(a)(1) on all sales of diesel fuel to the qualified retailer as of the effective date of the election. The effective date of an election made under this section is the date specified by the District Director in the written notice of liability sent to the seller and the qualified retailer under this paragraph (d)(4) upon validation of the election. See, however, paragraph (k)(1) of this section for rules regarding a revocation of the election provided by this section made by a qualified retailer, and paragraph (k)(2) of this section regarding a revocation made by the District Director.

(e) *Failure to make election.* If a retailer fails to make a valid election under this section with respect to any seller, this section does not apply and the retailer is liable for all taxes imposed by section 4041 on the sale of diesel fuel. If a qualified retailer has made a valid election under this section, but fails to make a valid election as to a seller not approved under an existing election, the qualified retailer may not purchase diesel fuel from that seller tax-paid under the terms of this section.

(f) *Penalty for failure to provide notice*—(1) *In general.* If a qualified retailer fails to provide a written notice (as described in paragraph (d)(1)(i)(A) of this section) to a seller with respect to whom the election is made, all sales of diesel fuel made by that seller to the qualified retailer are treated as sold by the qualified retailer in a sale to which section 4041(a)(1)(A) applies on the date that such fuel is sold to the qualified retailer. Sales of diesel fuel made to the qualified retailer by other sellers approved under a valid election are not affected by such a violation of the terms of the election. See section 6652(j)[k] for rules relating to the penalty imposed for failure to provide notice of the election to the seller.

(2) *Presumption where written consent received.* If a qualified retailer has received a written consent to liability for the excise tax imposed by section 4041(a)(1) from a seller, as required by paragraph (h) of this section, it will be presumed that the qualified retailer has provided the written notice required by paragraph (d)(1)(i)(A) of this section to the seller.

(g) *Retailer's notice to seller.* The notice that a qualified retailer is required to give to each seller under paragraph (d)(1)(i)(A) of this section in making an election under this section must be substantially in the following form:

RETAILER'S NOTICE TO SELLERS

[of election under 26 U.S.C. 4041(n)]

__________, 19__. I certify
(Date)
that I am the ______________
(owner or authorized agent)
of the retailer named below, and that I am authorized to execute this document. The purpose of this notice is to inform you that the named retailer is making an election under 26 U.S.C. 4041(n)(1) to have the diesel fuel excise tax imposed by 26 U.S.C. 4041(a)(1) imposed on the seller at the time such retailer purchases diesel fuel from any seller approved by the District Director under this election. A retailer may not purchase diesel fuel tax-paid from any person not approved by the District Director as a seller under a valid election. The District Director will not approve you as a seller under this election if you do not furnish the retailer with a written statement of consent to assume liability for the tax imposed by 26 U.S.C. 4041(a)(1) on all sales of diesel fuel to the retailer. The retailer must attach a copy of such consent to the form used to make this election, or the election will not be validated. If you are approved as a seller under this election, the District Director will notify you in writing of the effective date of your liability for the tax imposed by 26 U.S.C. 4041(a)(1) on all sales of diesel fuel to the retailer named below.

______________	______________
(Name of qualified retailer)	(Signature of owner or agent)
______________	______________
(E.I .N.)	(Name and title—type or print legibly
______________	
(Address)	
______________	

(h) *Seller's consent to liability*—(1) *In general.* To be approved as a seller under a qualified retailer's election, a seller, under paragraph (d)(2)(i) of this section, must consent in writing to assume liability for the tax imposed on the sale of diesel fuel by section 4041(a)(1), and certify, under penalties of perjury, that such seller—

(i) Is in the trade or business of selling diesel fuel for resale by a retailer;

(ii) Holds a valid Federal Employer's Identification Number (E.I.N.);

(iii) Has a regular place of business in a physical location (other than a post office box) in the state or territory in which the seller's principal place of business is located; and

(iv) Has complied with all laws regarding licensing, registration, bond, or other requirements to enable such person to sell diesel fuel within the law of each jurisdiction in which such person sells diesel fuel.

(2) *Form of consent.* A seller's written consent to liability for the tax imposed by section 4041(a)(1) must be in substantially the following form:

SELLER'S CONSENT TO LIABILITY

[for excise tax imposed on sale of diesel fuel
to a qualified retailer under 26 U.S.C. 4041(n)]

__________, 19__. I certify
(Date)
that I am the ______________
(owner or authorized agent)
of the seller named below, and that I am authorized to execute this document. Under penalties of perjury, I certify that the seller named below is in the trade or business of selling diesel fuel for resale by a retailer; holds a valid Federal Employer's Identification Number; has a regular place of business in a physical location (other than a post office box) in the state or territory in which the seller's principal place of business is located; and has complied with all laws regarding licensing, registration, bond, or other requirements to enable such person to sell diesel fuel under the law of each jurisdiction in which such person sells diesel fuel. The company named below consents to assume liability for the taxes imposed under 26 U.S.C. 4041(a)(1) on the sale of diesel fuel to the qualified retailer named below until such time as the qualified retailer's election is revoked. I understand that a failure to file any appropriate tax return or pay any tax due on the sale of diesel fuel to such qualified retailer, or otherwise to comply with any requirement incident to liability for the tax may result in the termination of my status as an approved seller of diesel fuel, and may subject me and/or the named company to prosecution under all relevant provisions of law, together with costs of prosecution therefor.

______________	______________
(Name of Seller)	(Signature of owner or authorized agent)
______________	______________
(Seller's EIN	(Name and title—type or print legibly)
______________	______________
(Seller's address)	(Name of retailer)

____________ (Retailer's EIN)

____

(Seller's phone number)

(i) *Liquid that is not treated as diesel fuel*—(1) *In general.* A liquid is not treated as diesel fuel for use in a diesel-powered highway vehicle for purposes of this section if the qualified retailer certifies in writing to the seller of such liquid that it will not be sold for use as a fuel in a diesel-powered highway vehicle. The certification must provide the qualified retailer's name, address and E.I.N., and be signed under penalties of perjury by the qualified retailer or a person having the power and authority to bind the qualified retailer. The retailer must give the certification to the seller on or before the earlier of the date of sale or delivery of the liquid. The qualified retailer must maintain sufficient records of its sales to establish the purpose for which the liquid is sold, and the person(s) to whom sold. See section 4041(n)(3)(C) for the definition of diesel fuel. See §48.4041-8(b)(4) for the definition of a diesel-powered highway vehicle.

(2) *Liability for violation of certification.* Notwithstanding the provisions of section 4041(n)(1), if—

(i) Liquid certified under this paragraph for use other than as a fuel in a diesel-powered highway vehicle is in fact used as diesel fuel; or

(ii) A qualified retailer, upon request of the District Director, fails to establish by probative evidence other than the certification described in paragraph (i)(1) of this section, that liquid purchased tax-free under paragraph (i)(1) of this section is not in fact used as a fuel in a diesel-powered highway vehicle,

such liquid shall be treated as a diesel fuel subject to tax under section 4041(a)(1), and the retailer, and not the seller, is liable for the tax on the sale of the liquid.

(3) *Acceptable form of certification.* A retailer's certification under paragraph (i)(1) of this section that a liquid is not to be sold for use as a fuel in a diesel-powered highway vehicle must be substantially in the following form:

RETAILER'S CERTIFICATION

[To support tax-free sale of liquid for use other
than as a fuel in a
diesel-powered highway vehicle
pursuant to 26 U.S.C.
4041(n)(3)(C)(ii)]

__________, 19___. I certify
(Date)
that I am the ______________
(owner or authorized agent)
of the qualified retailer named below, and that I am authorized to execute this document. I further certify that liquid fuel purchased from ______________ on
(name and address of seller)
__________, 19___ will be sold,
(date of purchase)
only for use other than as a fuel in a diesel-powered highway vehicle (as defined in Treasury Regulations §48.4041-8).

I understand that if this liquid is in fact used as a fuel for a diesel-powered highway vehicle, the qualified retailer named below will be liable for the tax which would have been imposed on the sale of the liquid to the retailer, but for this certification, and that both the qualified retailer and the user must be prepared to establish the purpose for which this liquid is used. I also understand that the fraudulent use of this certification to substantiate the tax-free sale of liquid otherwise treated as diesel fuel may subject me and all parties making such use of this certification to prosecution under all relevant provisions of law, together with costs of prosecution therefor.

Under penalties of perjury, I declare that I have executed this certification and that the statements made are to the best of my knowledge and belief, true, correct, and complete.

____________ ____________
(Name of qualified retailer) (Signature of owner or authoried agent)

____________ ____________
(E.I.N.) (Name and title—type or print legibly)

____
(Address)

____

(j) *Exemptions not to apply.* No exemption from the tax imposed by section 4041(a)(1) shall apply to a sale to which section 4041(n)(1) or 4041(n)(4)(A) applies. See sections 6416, 6427, and the regulations thereunder for provisions allowing a credit or refund for certain sales and uses of fuel.

(k) *Revocation of election*—(1) *By qualified retailer*—(i) *In general.* A qualified retailer may voluntarily revoke a valid election with respect to any seller at any time, by submitting a written statement to the District Director revoking the election. The revocation must provide the name, address, and E.I.N. of both the qualified retailer and the seller, and must be signed by the qualified retailer or an authorized agent. The District Director will then notify the qualified retailer and each seller as to whom the revocation is made, in writing, of the effective date of the revocation. A voluntary revocation made by a qualified retailer under this paragraph (k)(1)(i) takes effect on the date specified by the District Director in the written notice. Once the revocation becomes effective, the retailer, and not the seller, is liable for the tax imposed by section 4041(a)(1) on sales of diesel fuel to the retailer.

(ii) *Effective date of a new election following a voluntary revocation.* An election made by the retailer under this section with respect to a seller as to whom an election was previously revoked cannot have an effective date before the beginning of the fourth calendar quarter following the effective date of the revocation. Thus, for example, assume that in 1987 a qualified retailer, A, makes a valid election as to approved sellers X, Y, and Z. If A revokes the election with respect to X effective as of January 15, 1988, a subsequent election made by A with respect to X cannot become effective until April 1, 1989.

(iii) *Acceptable form for revocation.* The statement of revocation of the election under paragraph (k)(1) of this section must be substantially in the following form:

REVOCATION OF RETAILER'S ELECTION UNDER 26 U.S.C. 4041(n)

_____________, 19___. I certify
(Date)
that I am the _______________
(owner or authorized agent)
of the qualified retailer named below, and that I am authorized to execute this document. The qualified retailer named below hereby revokes the election made under 26 U.S.C. 4041(n)(1) with respect to the following seller(s):

Name and address of seller	*E.I.N.*
____________________	_______
____________________	_______
____________________	_______

I understand that by making this revocation, the qualified retailer named below will resume liability, as of a date specified by the District Director in a written notice of revocation, for the taxes imposed by 26 U.S.C. 4041(a)(1) on a taxable sale of diesel fuel purchased from a seller named above which is subsequently sold to an owner, lessee, or other operator of a diesel-powered highway vehicle for use as a fuel in such vehicle.

_____________ _____________
(Name of qualified retailer) (Signature of owner or authorized agent)

_____________ _____________
(E.I.N.) (Name and title—type or print legibly)

____
(Address)

____

(2) *Revocation by the District Director*—(i) *In general.* The District Director may revoke a qualified retailer's election at any time by notifying the qualified retailer and each of the affected sellers in writing, if, based on the facts and circumstances surrounding sales to such qualified retailer, the District Director determines that revocation is necessary to protect the revenue. A revocation made by the District Director takes effect on the date specified by the Direct Director in the written notice. A notice of revocation sent to a seller under this paragraph (k)(2) shall be limited to informing the seller of the fact and date of revocation only. A notice of revocation sent to a qualified retailer under this paragraph (k)(2) must include a statement of the reason for the revocation. Facts and circumstances which would support a District Director's decision to revoke a qualified retailer's election include, but are not limited to, situations in which the qualified retailer knowingly and willfully—

(A) Sells a liquid covered by an exemption certification described in paragraph (i) of this section as a fuel in a diesel-powered highway vehicle, if the retailer also fails to pay the tax due on such a sale;

(B) Forges a seller's written consent to liability for the tax imposed by section 4041(a)(1);

(C) Supplies false information as to a fact material to any aspect of the election provided by this section to either a seller or to the District Director; or

(D) Violates any of the terms of the election or uses the exemption certification described in paragraph (i) of this section in order to avoid the payment of any tax imposed by this chapter, or to postpone or in any manner to interfere with the collection of any such tax.

(ii) *Making a new election following revocation by the District Director.* Following revocation of a qualified retailer's election by the District Director, a subsequent election made by the retailer under this section cannot have an effective date before the beginning of the fourth calendar quarter following the effective date of the revocation.

(l) *Revocation of seller's consent to liability.* A seller may revoke consent to liability for the tax imposed on the sale of diesel fuel to a qualified retailer under section 4041(n) at any time by submitting a written statement to the District Director revoking the consent. The revocation must provide the name, address, and E.I.N. of both the seller and the qualified retailer, and must be signed by the seller or an authorized agent. The District Director will then notify the seller and the qualified retailer in writing of the effective date of the revocation. A revocation of consent made under this paragraph (l) takes effect on the date specified by the District Director in the written notice. Once the revocation becomes effective, the retailer, and not the seller, is liable for the tax imposed on the sale of diesel fuel by section 4041(a)(1).

(m) *Recordkeeping requirements*—(1) *Qualified retailer.* A qualified retailer who has made a valid election under this section must retain the following records with respect to the tax imposed by section 4041 (whether or not the qualified retailer incurs liability for such tax) for at least three years after the due date of the tax return for the return period to which the records relate, or the date such tax is paid, whichever is the later—

(i) A copy of the notice given to each seller under paragraph (d)(1)(i)(A) of this section stating that an election is being filed;

(ii) The original or a copy of the seller's written consent to liability for the tax imposed by section 4041(a)(1), required under paragraphs (d)(1)(i)(B) and (d)(2)(i) of this section;

(iii) Each notice received from the District Director under paragraph (d)(4) of this section stating that an election has been validated;

(iv) Each notice received from the District Director under paragraph (d)(2)(ii)(B) of this section stating that the District Director has revoked the approval of a seller under such qualified retailer's election;

(v) A copy of each certification given to a seller under paragraph (i)(1) of this section relating to a sale of liquid not treated as diesel fuel;

(vi) Each notice received from the District Director under paragraph (k)(1)(i) or (k)(2)(i) of this section stating that an election made under this section has effectively been revoked; and

(vii) Each notice received from the District Director under paragraph (l) of this section stating that a seller's consent to liability has effectively been revoked.

(2) *Seller.* Each seller must retain the following records with respect to the tax imposed by section 4041 (whether or not such seller incurs liability for such tax) for at least

three years after the due date of the tax return for the return period to which the records relate, or the date such tax is paid, whichever is the later—

(i) Each written notice received from a qualified retailer under paragraph (d)(1)(i)(A) of this section;

(ii) A copy of each consent furnished to a qualified retailer under paragraph (d)(1)(i)(B) or (c)(2)(i) of this section;

(iii) Each notice received from the District Director under paragraph (d)(4) of this section stating that the seller is liable for the tax imposed by section 4041(a)(1) on a sale of diesel fuel to a qualified retailer;

(iv) Each notice received from the District Director under paragraph (d)(2)(ii)(B) of this section stating that such seller's approval has been revoked;

(v) Each certification received from a qualified retailer under paragraph (i)(1) of this section relating to a sale of liquid not treated as diesel fuel;

(vi) Each notice received from the District Director under paragraph (k)(1)(i) or (k)(2)(i) of this section stating that a qualified retailer's election has effectively been revoked; and

(vii) Each notice received from the District Director under paragraph (1) of this section stating that a seller's consent to liability has effectively been revoked.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved February 9, 1988.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on February 29, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 1, 1988, 53 F.R. 6518)

Subchapter B.—Heavy Trucks and Trailers

Section 4052.—Definitions and Special Rules

26 CFR 145.4052-1: Special rules and definitions.

T.D. 8200

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER D, PART 145—TEMPORARY EXCISE TAX REGULATIONS UNDER THE HIGHWAY REVENUE ACT OF 1987 (PUB. L. 100-17)

Excise Tax on Heavy Trucks, Truck Trailers and Semitrailers, and Tractors

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document provides temporary regulations relating to the excise tax imposed on the retail sale of heavy trucks, truck trailers and semitrailers, and tractors. Changes in the applicable tax law were made by sections 505 and 506 of the Highway Revenue Act of 1987 (Title V of the Surface Transportation and Uniform Relocation Assistance Act of 1987). These regulations affect manufacturers, producers, importers, dealers, and lessors of these articles and will provide them with the guidance needed to comply with the law. In addition, the text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in *** [LR-17-86, page 923, this Bulletin].

DATES: Generally these regulations apply to heavy trucks, truck trailers and semitrailers, and tractors sold on or after October 1, 1987.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains amendments to the Temporary Excise Tax Regulations (26 CFR Part 145) under section 4052 of the Internal Revenue Code of 1986 (Code), as amended by sections 505 and 506 of the Highway Revenue Act of 1987 (Title V of the Surface Transportation and Uniform Relocation Assistance Act of 1987) (Pub. L. 100-17, 101 Stat. 256, 258-59) (''the Act''), relating to the excise tax on the sale of heavy trucks, truck trailers and semitrailers, and tractors. The amendments modify temporary regulations previously promulgated under section 512 of the Highway Revenue Act of 1982 (Title V of the Surface Transportation Assistance Act). The temporary regulations provided by this document will remain in effect until superseded by final regulations on this subject.

Section 4051(a) of the Code imposes a 12 percent tax on the first retail sale of heavy trucks, truck trailers and semitrailers, and tractors. Section 505(a) of the Act amended section 4052(a)(1) to provide that the term ''first retail sale'' means ''the first sale, for a purpose other than for resale or leasing in a long-term lease, after manufacture, production, or importation''.

Under section 4052(a)(1), the leasing of an article on a long-term basis is treated as the first retail sale, and the tax under section 4051 is imposed on such article at the time the article is leased, rather than at the time the manufacturer, producer, or importer sells the article to the lessor. Section 4052(f) provides that the term ''long-term lease'' means any lease with a term of 1 year or more. The leasing of an article on a short-term basis (*i.e.*, less than one year) before the first retail sale of such article is treated as a taxable use under section 4052(a)(3), and the tax under section 4051 is imposed at the time of that lease.

The tax imposed on either a long-term or short-term lease is computed on a price established by the Commissioner that is based on the retail sales price of similar articles (a constructive sales price). See discussion of ''Presumptive retail sales price'' w.

Definition of first retail sale

Temporary regulations §145.4052-1, relating to the excise tax on heavy trucks, truck trailers and semitrailers, and tractors, were revised by temporary regulations published in the *Federal Register* on September 13, 1985 (T.D. 8050) (50 FR 37350) [1985-2 C.B. 206]. Those revised regulations provided that a sale by a manufacturer, producer, or importer is treated as the first retail sale unless either (a) the purchaser is not in the business of leasing and intends to resell the article, or (b) the seller and the purchaser are registered under section 4222 (prescribing rules relating to the registration required to make tax-free sales), and the seller receives a certificate indicating the purchaser's intent to resell the articles.

Section 4052, as amended by the Act, treats a long-term lease as a first retail sale. Sections 145.4052-1(a)(1), (a)(2), and (a)(3) of these temporary regulations set forth certification requirements that determine when the first retail sale of an article occurs.

Certification requirements

Section 145.4052-1(a)(2) of these temporary regulations provides that the sale of an article will be taxable as the first retail sale unless (a) the sale is a tax-free sale under section 4221, (b) the purchaser and seller are registered under §48.4222(a)-1 and the seller in good faith accepts a proper certification from the purchaser that the purchaser intends either to lease the article on a long-term basis or to resell the article, or (c) there has been a prior taxable sale of the article. "Taxable sale" for these purposes includes a long-term lease or a taxable use, such as a short-term lease. If the purchaser does not meet one of the exceptions in §1.4052-1(a)(2), the seller will be liable for the tax imposed on the sale.

Thus, §145.4052-1(a)(2) allows a purchaser who intends either to lease on a long-term basis or to resell an article to purchase such article tax-free. In such cases the tax under section 4051 will be imposed on a subsequent taxable sale or use of the article.

Paragraphs (a)(4) and (d)(3)(ii) of §145.4052-1 set forth special rules regarding imposition of the tax. Section 145.4052-1(a)(4) provides that in certain circumstances tax will be imposed on the resale or long-term lease of a tax-paid trailer or semitrailer and the seller of such trailer or semitrailer shall be liable for such tax. Under §145.4052-1(a)(4) the seller may in such cases reduce the tax liability by the amount of tax previously paid with respect to the article.

Section 145.4052-1(d)(3)(ii) provides that the tax under section 4051 shall be computed on a price that includes a presumed markup when a person other than a manufacturer, producer, or importer is designated as the seller of an article but (a) such person does not perform significant activities relating to the processing of the sale of the article and (b) the principal purpose of processing the sale through such person is to avoid or evade the presumed markup imposed under section 4052(b)(4)(A)(ii).

Presumptive retail sales price

In order to achieve comparable tax treatment along long-term leases, sales by manufacturers, producers, or importers, and retail sales by other persons, sections 505(b) and 506(a) of the Act amended section 4052(b) by adding new paragraphs (b)(3) and (4). These paragraphs were added to ensure that the tax base of most transactions considered to be taxable sales subject to section 4051 includes either an actual or a presumptive retail markup. As a result, sections 4052(b)(3) and (4) provide that the tax imposed by sections 4051 shall, under certain circumstances, be computed on a presumptive retail sales price (*i.e.*, a tax base that includes a presumed markup).

Section 4052(b)(3) provides that the tax imposed on any long-term lease that is treated as the first retail sale of an article shall be computed on a tax base that includes the price at which the article was sold to the lessor, the cost of any parts and accessories installed by the lessor, and an amount equal to a presumed markup. Section 145.4052-1(c)(5) of the regulations is amended to provide that the tax imposed on a short-term lease by a person other than a manufacturer, producer or importer shall also be computed on a tax base that includes the price at which the article was sold to the lessor, the cost of any parts and accessories installed by the lessor, and an amount equal to the presumed markup. However, the leasing of an article by a person other than a manufacturer, producer, or importer will not be subject to tax under section 4051 if such article was previously subject to tax under that section.

Similarly, section 4052(b)(4) provides that the tax imposed on a sale by a manufacturer, producer, or importer shall be computed on a tax base that includes an actual or constructive sales price of the article and an amount equal to a presumed markup.

For purposes of these temporary regulations, a single presumed markup percentage of four percent has been established for most articles subject to section 4051. However, truck trailers, semitrailers, and remanufactured trucks and tractors are subject to a zero percent markup. The imposition of a presumed markup percentage greater than zero percent on these articles is not necessary to carry out the purpose of the section 4051 retail tax because retail sales of trailers and semitrailers are generally made by trailer manufacturers. Similarly, remanufactured trucks and tractors generally are not sold through an established retail distribution network.

The presumed markup percentage is defined under section 4052(b)(3)(B) as "the average markup percentage of retailers of articles of the type involved." The Internal Revenue Service is currently examining whether it is appropriate to exercise its regulatory authority to establish additional markup percentages for different categories of articles. A tax system involving different markups raises a variety of problems relating to administration and enforcement. Therefore, the Service is requesting comments and suggestions relating to this particular issue in order to administer this tax fairly and efficiently.

SPECIAL ANALYSES

No general notice of proposed rulemaking is required by 5 U.S.C. 553(b) for temporary regulations. Accordingly, the Regulatory Flexibility Act (5 U.S.C. Chapter 6) does not apply, and no regulatory flexibility analysis is required for this rule. The Commissioner of Internal Revenue has determined that this rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis is therefore not required.

* * * * *

Adoption of amendments to the regulations.

Accordingly, 26 CFR Part 145 is amended as follows:

PART 145—TEMPORARY EXCISE TAX REGULATIONS UNDER THE HIGHWAY REVENUE ACT OF 1987 (Pub. L. 100–17)

Paragraph 1. The authority for part 145 continues to read in part:

Authority: 26 U.S.C. 7805. *** Section 145.4052-1 also issued under 26 U.S.C. 4052(d).

Par. 2. Section 145.4052-1 is amended as follows:

1. Paragraph (a) is revised to read as set forth below.

2. The heading and text for paragraph (b) are revised to read as set forth below.

3. Paragraph (c)(1) is amended by deleting the first sentence and inserting in its place, "For purposes of this section and §145.4051-1, the use of an article will be deemed to be a sale of the article." and by removing from the second sentence the words "unless such article is thereafter sold for resale".

4. Paragraph (c)(5) is amended by deleting the first sentence from paragraph (c)(5)(i) and inserting in its place "Except as provided in paragraphs (c)(5)(ii) and (c)(5)(iii) of this section," and by adding a new paragraph (c)(5)(iii) as set forth below.

5. Paragraph (d) is amended by redesignating paragraphs (d)(2), (d)(3), and (d)(4) as paragraphs (d)(8), (d)(9), and (d)(10), respectively, and by adding new paragraphs (d)(2), (d)(3), (d)(4), (d)(5), (d)(6), and (d)(7) to read as set forth below.

6. Paragraphs (d)(2) is amended by removing the words "paragraph (d)(2)(iii)" from the second sentence of paragraph (d)(2)(iii) and by inserting, in their place, the words "paragraph (d)(8)(iii)".

7. Paragraph (f) is removed.

8. Paragraph (e) is redesignated as paragraph (f) and a new paragraph (e) is added to read as set forth below.

9. A new paragraph (g) is added to read as set forth below.

§145.4052-1 Special rules and definitions.

(a) *First retail sale*—(1) *General rule*. For purposes of section 4052(a)(1) and §145.4051-1, the term "first retail sale" means a taxable sale described in paragraph (a)(2) of this section.

(2) *Taxable sale*. The sale of an article is a taxable sale unless—

(i) The sale is a tax-free sale under section 4221,

(ii) Both the purchaser and the seller are registered under section 4222 and §48.4222(a)-1 and the seller has in good faith accepted from the purchaser a proper certification, as provided in paragraph (a)(6) of this section, executed in good faith, that the purchaser intends to lease such article on a long-term basis or resell such articles, or

(iii) There has been a prior taxable sale of the article. Notwithstanding the preceding clause, the sale of a chassis or body of a trailer or semitrailer ("trailer or semitrailer") less than six months after a taxable sale of the article shall be treated as a taxable sale.

(3) *Computation of tax*—(i) *In general*. If the sale of an article is a taxable sale under paragraph (a)(2) of this section, the tax shall be computed on the price as determined under paragraph (d) of this section.

(ii) *Exception*. If the taxable sale of an article is a taxable use of such article under paragraph (c) of this section, the tax shall be computed on the price as determined under paragraph (c) of this section.

(4) *Special rule for tax-paid trailer and semitrailer*. In the case of a taxable sale of a trailer or semitrailer less than six months after a taxable sale of the article, the seller in the subsequent sale ("the subsequent seller") may claim a credit equal to the amount of tax previously paid by another person ("the previous taxpayer") under section 4051(a)(1) with respect to the prior taxable sale of the article. The credit for such tax will be allowed to the subsequent seller only if the form on which the credit is claimed is accompanied by a statement, signed by the subsequent seller, indicating the amount of the credit being claimed under this paragraph (a)(4) and stating that—

(i) The subsequent seller has not been repaid any portion of such tax by the previous taxpayer,

(ii) The subsequent seller has not provided the previous taxpayer with written consent to allow the previous taxpayer to claim a credit or refund of such tax under section 6416(a), and

(iii) The subsequent seller has records (*e.g.*, invoices) substantiating the amount of tax paid by the previous taxpayer with respect to the prior taxable sale of such article.

In no case shall the amount of the credit allowable under this paragraph (a)(4) with respect to an article exceed the tax liability of the subsequent seller with respect to the sale of such article.

(5) *No installment payments of tax*. If a lease or an installment sale (or another form of sale under which the sales price is paid in installments) is, or is deemed to be, a taxable sale under this section, then the liability for the entire tax arises at the time of the lease or installment sale. No portion of the tax is deferred by reason of the fact that the sales price is paid in installments.

(6) *Certificate*. A certificate signed by the purchaser, or an officer or employee authorized by the purchaser to sign the certificate, may be accepted by a seller in support of a nontaxable sale to the purchaser. If it is impracticable to furnish a separate certificate for each sale because of the frequency of sales to such purchaser, a certificate covering all orders between given dates (such period not to exceed 12 calendar quarters) will be acceptable. The purchaser may revoke the certificate by sending a written revocation to the seller. The certificate and proper records of invoices, orders, etc., relating to sales made pursuant to such certificate, must be retained by the seller as provided in section 6001 and the regulations thereunder. The certificate shall be substantially in the following form:

EXEMPTION CERTIFICATE

I hereby certify that I am ______
(Title)
of ______________________,
(Name of purchaser)
that I am authorized to execute this certificate, and that:

(Check appropriate line)

______ the article or articles specified in the accompanying order, or on the reverse side hereof, (or)

______ all orders placed by the purchaser for the period commencing ______ (Date) (period not to exceed 12 calendar quarters), are purchased either for resale or for lease on a long-term basis.

I have filed Form 637 and have received registration number ______.

I understand that the fraudulent use of this certificate to secure exemption will subject me and all parties making such fraudulent use to a fine of not more than $10,000, or to imprisonment for not more than 5 years, or both, together with costs of prosecution.

____
(Signature)

____
(Address)

(7) *Registration*. Section 4222 and the regulations thereunder shall apply to persons making sales which are not treated as taxable sales pursuant to paragraph (a)(2)(ii) of this section.

(b) *Tax treatment of leases*—(1) *Long-term lease*. For purposes of this section and §145.4051-1, the leasing of an article on a long-term basis (as defined in paragraph (d)(6) of this section) will be deemed to be a sale of the article and will be deemed to be a taxable sale unless one of the exceptions contained in paragraph (a)(2) of this section applies. Thus, if a dealer purchases an article tax-free under an exception contained in paragraph (a)(2) of this section and then leases the article on a long-term basis, the leasing of the article will be treated as a taxable sale.

(2) *Short-term lease*. For purposes of this section and §145.4051-1, the leasing of an article on a short-term basis (as defined in paragraph (d)(6) of this section) will be deemed to be a taxable use of such article under paragraph (c) of this section and will be deemed to be a taxable sale unless one of the exceptions contained in paragraph (a)(2) of this section applies.

(3) *Computation of tax*—(i) *Long-term lease by manufacturer, producer, or importer*. When a manufacturer, producer, or importer is the lessor of an article on a long-term basis (as defined in paragraph (d)(6) of this section) and such lease is deemed to be a taxable sale under paragraph (b)(1) of this section, the tax shall be computed on a presumptive retail sales price as determined under paragraph (d)(4)(i) of this section. The manufacturer, producer, or importer shall be liable for the tax as if the article were sold at retail by such manufacturer, importer, or retailer.

(ii) Long-term lease by persons other than manufacturer, producer, or importer. When a person other than a manufacturer, producer, or importer is the lessor of an article on a long-term basis (as defined in paragraph (d)(6) of this section) and such lease is deemed to be a taxable sale under paragraph (b)(1) of this section, the tax shall be computed on a presumptive retail sales price as determined under paragraph (d)(5)(i) of this section. Such person shall be liable for the tax as if the article were sold at retail by such person.

* * * * *

(c) *Use treated as a sale*. ***

(5) *Computation of tax*—(i) ***

(iii) In the case of any short-term lease (as defined in paragraph (d)(6) of this section) by any person other than a manufacturer, producer, or importer (or related person as defined in paragraph (d)(2)(ii) of this section) of an article that is deemed to be a taxable use of such article under paragraph (b)(2) of this section, the tax imposed by section 4051(a)(1) shall be computed on a price equal to the sum of—

(A) The price (as determined under paragraph (d) of this section) at which such article was sold to the lessor plus the cost of any parts and accessories installed by the lessor (or an agent of the lessor) on such article before the first use or lease by the lessor, plus

(B) The product of the sum described in paragraph (c)(5)(iii)(A) of this section and the presumed markup percentage (as defined in paragraph (d)(7) of this section).

* * * * *

(d) *Determination of price*—(1) *In general*. ***

(2) *Presumptive retail sales price where tax paid by manufacturer, producer, or importer*—(i) *In general*. In the case of a taxable sale (other than a taxable sale described in paragraph (b)(1) of this section) where a manufacturer, producer, importer, or related person is liable for the tax imposed by section 4051, such tax shall be computed on a price equal to the sum of—

(A) The price that would (but for this paragraph (d)(2)) be determined under this paragraph (d), and

(B) The product of the price determined under paragraph (d)(2)(i)(A) of this section and the presumed markup percentage (as defined in paragraph (d)(7) of this section).

(ii) *Related person defined*—(A) *In general*. Except as provided in paragraph (d)(2)(ii)(B) of this section, the term "related person" means any person that is a member of the same controlled group (within the meaning of section 5061(e)(3)) as the manufacturer, producer, or importer.

(B) *Exception for permanent retail establishment*. A person shall not be treated as related person with respect to the sale of any article if—

(*1*) Such person sells the article through a permanent retail establishment in the normal course of business of being a retailer, and

(*2*) Such person has records (*e.g.*, invoices) that substantiate that the article was sold for a price that included a markup equal to or greater than the presumed markup percentage (as defined in paragraph (d)(7) of this section).

(3) *Retail sales price where tax paid by person other than a manufacturer, producer, importer, or related person*. (i) *In general*. In the case of a taxable sale (other than a taxable sale defined in paragraph (b)(1) of this section) where a person other than a manufacturer, producer, importer, or related person is liable for the tax imposed by

section 4051, such tax shall be computed on a price determined under paragraph (d)(1) of this section.

(ii) *Exception.* When a person other than a manufacturer, producer, importer, or related person is liable for the tax imposed by section 4051, such tax shall be computed on a price determined under paragraph (d)(2)(i) of this section if—

(A) Such person does not perform any significant activities relating to the processing of the sale of an article,

(B) The principal purpose for processing the sale through such person is to avoid or evade the presumed markup under paragraph (d)(2)(i)(B) of this section, and

(C) Such person does not have records (*e.g.*, invoices) substantiating that the article was sold for a price that included a markup equal to or greater than the presumed markup percentage as defined in paragraph (d)(7) of this section.

(4) *Presumptive retail sales price in the case of a lease by a manufacturer, producer, or importer.* In the case of any long-term lease (as defined in paragraph (d)(6) of this section) by a manufacturer, producer, importer, or a related person (as defined in paragraph (d)(2)(ii) of this section) of an article that is deemed to be a taxable sale of such article under paragraph (b)(1) of this section, the tax imposed by section 4051(a)(1) shall be computed on a price equal to the sum of—

(i) A constructive sales price established by the Commissioner based on the price at which such article would be sold by a manufacturer, producer, or importer in a sale other than a taxable sale (*e.g.*, a sale to which the exceptions contained in paragraph (a)(2)(ii) of this section applies) on the date the lease is made, and

(ii) The product of the constructive sales price referred to in paragraph (d)(4)(i) of this section and the presumed markup percentage as defined in paragraph (d)(7) of this section.

(5) *Presumptive retail sales price in the case of a long-term lease by any other person.* In the case of any long-term lease (as defined in paragraph (d)(6) of this section) of an article in which any person other than a manufacturer, producer, or importer (or related person as defined in paragraph (d)(2)(ii) of this section) is the lessor and the long-term lease is deemed to be a taxable sale of such article under paragraph (b)(1) of this section, the tax imposed by section 4051(a)(1) shall be computed on a price equal to the sum of—

(i) The price (as determined under this paragraph (d)) at which such article was sold to the lessor plus the cost of any parts and accessories installed by the lessor (or an agent of the lessor) on such article before the first use by the lessee or leased in connection with such long-term lease, and

(ii) The product of the sum described in paragraph (d)(5)(i) of this section and the presumed markup percentage as defined in paragraph (d)(7) of this section.

(6) *Long-term and short-term lease defined.* For purposes of this section, the term "long-term lease" means any lease with a term of one year or more. The term "short-term lease" means any lease with a term of less than one year. In determining a lease term, options to renew shall be taken into account. In addition, two or more successive leases that are part of the same transaction (or a series of related transactions) with respect to the same or substantially similar article, shall be treated as one lease.

(7) *Presumed markup percentage*—(i) *In general.* Except as provided in paragraph (d)(7)(ii) of this section, for purposes of this section the term "presumed markup percentage" shall be four percent.

(ii) *Exceptions.* For purposes of this section the "presumed markup percentage" for trailers, semitrailers, and remanufactured automobile truck chassis and bodies and tractors shall be zero percent. For purposes of this section an article is a remanufactured article if—

(A) The refurbishing, renovation, or repair of the article causes it to be subject to the tax imposed by section 4051, and

(B) Before remanufacture, such article was previously subject to the tax imposed by section 4051 (or section 4061 prior to its repeal).

* * * * *

(e) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). M manufactures trucks that are taxable under section 4051. On July 11, 1988, D a corporation that is a dealer, purchases one truck from M for $50,000. M does not own any stock in D. Prior to this transaction, D gave M a certificate that meets the specifications detailed in paragraph (a)(6) of this section. The certificate states that the truck will be resold or leased on a long-term basis. M's sale to D is not a taxable sale of the truck (within the meaning of paragraph (a)(2) of this section). On July 20, 1988, D resells the truck to a purchaser, P, for $52,000. The additional $2,000 includes the dealer's mark-up, costs of transporting the truck from M to D, and overhead. No parts or accessories were added to the truck. P did not give D a certificate and did not have an agreement with D under which all vehicles purchased were to be resold. The sale of the truck by D to P is a taxable sale within the meaning of paragraph (a)(3) of this section. Therefore, D has a tax liability of $6,240 (12% × $52,000).

Example (2). Assume the same facts as in example (1) except that M owns 80 percent of D's stock. D and M are members of the same controlled group (within the meaning of section 5061(e)(3)). Therefore, D is a related person under paragraph (d)(2)(ii)(A) of this section. On July 20, 1988, D sells the truck to P for $51,000. D does not have records substantiating that the truck was sold for a price that included a markup equal to or greater than the presumed markup percentage. The tax on the sale of the truck to P is determined under paragraph (d)(2)(i) of this section. Therefore, D has a tax liability of $6,240 (12% × ($50,000 + ($50,000 × 4%))).

Example (3). Assume the same facts as in example (1) except that D does not perform any significant activities relating to the sale. Assume further that the principal purpose for processing the sale through D is to avoid the presumed markup and that D did not sell the truck for a price that included a markup equal to or greater than the presumed markup percentage. D, however, is designated the seller of the truck on the invoice. Pursuant to paragraph (d)(3)(ii) of this section, the price of the truck shall be computed on a price determined under paragraph (d)(2)(i). Therefore, D, the taxpayer, has a tax liability of $6,240 [12% × ($50,000 + ($50,000 × 4%))].

Example (4). Assume the same facts as in example (1) except that on July 20, 1988, D leases the truck for a two-year period (*i.e.*, on a long-term basis) to L, a lessee. D's leasing of the truck to L is treated as a taxable sale under paragraph (b)(1) of this section and the tax is computed on the price as determined under paragraph (d)(5)(i) of this section. D has a tax liability of $6,240 [12% × ($50,000 + ($50,000 × 4%))].

Example (5). Assume the same facts as in example (1) except that on July 20, 1983, D leases the truck to L for a six-month period (*i.e.*, a short-term lease). The lease is treated as a use under paragraph (b)(2) of this section. The tax is computed on the price as determined under paragraph (c)(5) of this section. D has a tax liability of $6,240 [12% × $50,000 + $50,000 × 4%))].

Example (6). Assume the same facts as in example (1) except that D does not give M a certificate. The sale by M to D is a taxable sale of the truck under paragraph (a)(2) of this section. M's tax liability is $6,240 [12% × $50,000 + ($50,000 × 4%))]. On July 20, 1988, D leases the truck to L, a lessee. The lease has a two-year term. Since the lease to L occurred after a taxable sale of the truck, paragraph (b)(1) of this section does not apply, and the lease is not treated as a taxable sale under this section.

Example (7). M manufactures trucks that are taxable under section 4051. On July 11, 1988, M leases a truck to a lessee, L. The lease has a two-year term. The lease is treated as a taxable sale under paragraph (b)(1) of this section and the tax is computed on the price as determined under paragraph (d)(4)(i) of this section. The constructive sales price established by the Commissioner, pursuant to paragraph (d)(4)(i) of this section, is $50,000. M has a tax liability of $6,240 [12% × ($50,000 + ($50,000 × 4%))].

Example (8). Assume the same facts as in example (7) except that the lease has a six-month term. The lease is treated as a taxable use under paragraph (b)(2) of this section and the tax is computed under paragraph (c)(5) of this section. The constructive sales price established by the Commissioner, pursuant to paragraph (c)(5)(i) of this section, is $52,000. M has a tax liability of $6,240 (12% × $52,000).

Example (9). M manufactures truck trailers and semitrailers that are taxable under section 4051. On July 5, 1988, D, a dealer, purchases a trailer from M for $10,000. Prior to this transaction, D did not give M a certificate and D did not have an agreement with M to resell all articles purchased. The sale by M to D is a taxable sale of the trailer under paragraph (a)(2) of this section. M has a tax liability of $1,200 (12% × $10,000 + ($10,000 × 0%)).

Example (10). Assume the same facts as in example (9) except that on July 12, 1988, D resells the trailer to P, a purchaser, for $10,500 (the additional $500 includes the dealer's markup, costs of transporting the trailer from M to D, and overhead). P did not give D a certificate and P did not have an agreement with D that stipulates that all articles purchased were to be leased on a long-term basis or resold. The sale of the trailer by D to P is a taxable sale within the meaning of paragraph (a)(3) of this section. Therefore, D has a tax liability of $1,260 (12% × $10,500). D, however, may file for a credit of $1,200 under section 6402 provided that the requirements of paragraph (a)(4) of this section are met.

* * * * *

(g) *Effective date*—(1) *In general.* Except as provided below, the provisions of this section shall be effective for articles sold or leased on or after April 1, 1983.

(2) *Certain sales made prior to November 12, 1985.* If a sale to a lessor before November 12, 1985, was not taxable under §145.4052-1 of the temporary regulations contained in 26 CFR part 145 revised as of April 1, 1983, (the "prior regulations") and it was so treated by the parties, a subsequent sale or lease that was or would have been treated as the first retail sale of the article under the prior regulations will be treated as a taxable sale for purposes of this section. The tax on such subsequent sale will be based on a price determined under paragraph (d) of this section. For example, if an article was sold to a purchaser who intended to lease such article long-term, the sale would not have been taxable under the prior regulations even though the seller did not receive a certificate of the purchaser's intent to lease the vehicle. If such a sale was treated as nontaxable by the parties, and the purchaser leases it long-term on or after October 1, 1987, the lease will be treated as a taxable sale of the article. The tax is to be computed under paragraph (b)(3)(ii) of this section and the price will be computed under paragraph (d)(5).

(3) *Certain sales made after November 11, 1985, and before October 1, 1987*—(i) *Sales not treated as taxable by purchaser and seller.* If a sale to a purchaser after November 11, 1985, and before October 1, 1987, was not treated as taxable by the parties, a subsequent sale or lease that was or would have been treated as the first retail sale of the article under the temporary regulations published in the September 13, 1985, issue of the *Federal Register* (50 FR 37350) [T.D. 8050, 1985-2, C.B. 206]("the interim regulations") will be treated as taxable sale for purposes of this section. The tax on a sale or lease after September 30, 1987, will be based on a price determined under paragraph (d) of this section. For example, if a vehicle was sold on January 3, 1987, to a purchaser who intended to resell the article and who was not in the business of leasing to any extent, the sale would not have been taxable under the interim regulations even though the seller did not receive a certificate indicating the purchaser's intent to resell the article. If such a sale was not treated as a taxable sale by the parties, and the purchaser resells the article, the resale will be treated as a taxable sale of the article under paragraph (a)(2) of this section.

(ii) *Sales treated as first retail sale by purchaser and seller.* If the sale of an article after November 11, 1985, and before October 1, 1987, was treated as a taxable sale by the parties and tax was paid with respect to the article under the interim regulations, the subsequent sale of the article by the purchaser will not be treated as a taxable sale under paragraph (a)(2) of this section.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved April 19, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 11, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 12, 1988, 53 F.R. 16867)

Chapter 32.—Manufacturers Excise Taxes
Subchapter D.—Recreational Equipment
Part I.—Sporting Goods

Section 4161.—Imposition of Tax

Definitions and standards of taxation are provided for articles of sport fishing equipment listed in section 4162(a) of the Code. See Rev. Rul. 88-52, below.

Section 4162.—Definitions; Treatment of Certain Resales

(Also Section 4161.)

Sport fishing equipment; definitions; standards of taxation. Definitions and standards of taxation are provided for articles of sport fishing equipment listed in section 4162(a) of the Code.

Rev. Rul. 88-52

PURPOSE

This revenue ruling defines certain items of sport fishing equipment that are enumerated in section 4162(a) of the Internal Revenue Code and that are subject to the excise tax under section 4161(a)(1).

LAW

Section 4161(a)(1) of the Code imposes on the sale of any article of sport fishing equipment by the manufacturer, producer, or importer a tax equal to 10 percent of the price for which it is sold.

Section 4161(a)(2)(A) of the Code provides that in the case of an electric outboard motor or sonar device suitable for finding fish, section 4161(a)(1) shall be applied by substituting "3 percent" for "10 percent."

Section 4161(a)(2)(B) of the Code provides that the tax imposed by section 4161(a)(1) on any sonar device suitable for finding fish shall not exceed $30.

Section 4161(a)(3) of the Code provides that in the case of any sale by the manufacturer, producer, or importer of any article of sport fishing equipment, such article shall be treated as including any parts or accessories of such article sold on or in connection therewith or with the sale thereof.

Section 4162(a) of the Code enumerates articles of sport fishing equipment taxable under section 4161(a). Section 4162(b) provides that certain sonar devices shall not be considered sonar devices suitable for finding fish.

DEFINITIONS

In order to assist taxpayers in determining the taxability of fishing equipment, the articles enumerated in section 4162(a) and 4162(b) are defined as follows:

(1) *Fishing rods and poles (and component parts therefor).* A fishing rod or pole is any tube or shaft-like device (regardless of size or length) made of natural, synthetic, or other material that is designed or used to cast, troll, or otherwise present a bait or lure to fish. The term "fishing rods and poles" does not include bamboo poles that are not designed or intended for use in fishing. Any pole intended for attaching a fishing line to or through is considered a fishing rod or pole. Jigsticks and other similar devices used in ice fishing are considered fishing rods or poles.

A "component part" of a fishing rod or pole is a rod handle, guide, reel seat, blank rod, tip-top, ferrule, or any other device that is designed to be attached to a pole or rod for use in fishing. No tax is imposed on the sale of strike indicators (alarm switches that attach to a fishing rod) and carrying cases for fishing rods.

(2) *Fishing reels.* A fishing reel is any mechanical device that can be attached to a rod or pole and is used or designed for dispensing and retrieving fishing line. The term includes reels used in fly fishing, reels or spools employed for dispensing and retrieving the line attached to arrows and spears used in fishing, and reels or spools designed for use in ice fishing.

(3) *Fly fishing lines and other fishing lines not over 130 pounds test.* These lines include all lines, either monofilament, multifilament, synthetic, metal, organic, or inorganic, that are used or designed for the purpose of attaching lures, hooks, flies, bobbers, sinkers, or any other item of terminal tackle, including lines used to attach items of terminal tackle to one another, such as leaders. Fishing lines over 130 pounds test are not taxable. (Such lines are able to suspend a 130 pound weight without breaking or stretching more than five percent of line length while suspending that weight.)

(4) *Fishing spears, spear guns, and spear tips.* A fishing spear is any tube or shaft-like device that ends in a sharp tip and is designed for the purpose of spearing fish. A spear gun is any device designed for propelling a shaft or tube-like device through the water for the purpose of spearing fish. A spear tip is any device that ends in one or several sharp tips, that may be attached to a shaft or tube-like device, and that is designed for the purpose of spearing fish. Fishing spears, spear guns, and spear tips do not include bows and fish arrows used in the sport of bowfishing.

(5) *Items of terminal tackle.* Terminal tackle includes, but is not limited to the following items—

(A) *Leaders.* A leader is any article used for attaching the end of a fishing line to a hook or lure or any other device of terminal tackle. The term includes, but is not limited to, swivels and snaps.

(B) *Artificial lures.* Artificial lures are all devices (from whatever materials made) that are designed to be attached to a fishing line, and that simulate an article considered edible to fish or that otherwise are intended to induce a fish to attempt to confront, swallow, bite, or consume the device. An artificial lure usually includes one or more attached hooks. Artificial lures include, but are not limited to, plugs, spoons, jigs, feathers, spinners, soft-plastic lures, and spear fishing decoys.

(C) *Artificial baits.* An artificial bait is any bait that simulates an article considered edible to fish and that is designed to be attached to a hook or lure. The term does not include preserved packaged natural baits.

(D) *Artificial flies.* An artificial fly consists of a hook to which feathers, beads, lead, or other items are attached to make the article resemble an insect or any other organism considered edible to fish. An artificial fly is usually designed to be attached to a fishing line, leader, swivel, or snap.

(E) *Fishing hooks.* A fishing hook is any curved or bent metallic device that terminates in a sharp point and is designed for the purpose of catching, holding, or pulling fish or fishing bait.

(F) *Bobbers.* A bobber is any device used as a means to suspend a fishing line or lure in the water column, or that can be used to visually track the location and status of fishing line and associated hooks and bait. A bobber can be attached to fishing line and is made of wood, cork, plastic, styrofoam, or other material. It can be any size, shape, or color.

(G) *Sinkers.* A sinker is any device wholly or in part made of lead or another metallic substance designed to attach to a fishing line or to items of terminal tackle in order to cause the terminal tackle to descend into the water column. A sinker can be of any size or shape.

(H) *Snaps.* A snap is a catch, clip, or fastening device. It is designed at one end to attach to a swivel or tie onto the end of a fishing line and to attach, by means of a clasp at the other end, to items of terminal tackle.

(I) *Drayles.* A drayle (or drail) is any article made, wholly or in part, of lead or another metallic substance that can be tied or otherwise attached to the end of a fishing line to which are attached leaders or other items of terminal tackle. A drayle (drail) is designed to be trolled behind a boat so that the line or terminal tackle descends into the water column.

(J) *Swivels*. A swivel is any device designed so that fishing line and/or items of terminal tackle can be attached to one or more of the ends of the device. The device is also designed so that the end(s) of the fishing line and/or items of terminal tackle attached to the end(s) of the device can pivot freely.

No tax is imposed on the sale of items otherwise considered to be terminal tackle if they are designed for use and ordinarily are used on fishing line over 130 pounds test. The term "terminal tackle" does not include natural baits.

(6) *Specific items of fishing supplies, accessories and equipment*.

(A) *Fish stringers*. A fish stringer is any article designed or sold as a device for attaching fish through the opercular opening and mouth. The term includes any device consisting of a series of metal or plastic clips, as well as a cord consisting of a ring and threader connected by the cord.

(B) *Creels*. A creel is any portable container designed for storing and carrying fish from the time they are caught until the time they are removed from the container for consumption or preservation. A creel can be made of any material.

(C) *Tackle boxes*. A tackle box is a portable container primarily designed, intended for use, or sold as an item in which to store or organize fishing paraphernalia like hooks, lures, flies, sinkers, or bobbers, until the items are placed on a fishing line, rod, or reel. A tackle box can be made of any material.

(D) *Bags, baskets, and other containers designed to hold fish*. A bag, basket, or other container designed to hold fish is a container designed to be hung over the side of a boat or other structure to keep fish captive and alive in the water. These containers may be made of any material. The term includes collapsible baskets or any similar device designed for the same purpose.

(E) *Portable bait containers*. A portable bait container is any portable device designed or sold as an article to hold or transport bait in connection with recreational fishing activities. Examples of portable bait containers are minnow buckets, killy cars (floating cages), and grasshopper cages.

(F) *Fishing vests*. A fishing vest is a garment designed for storing various lures, flies, hooks, or other fishing paraphernalia. A fishing vest may also have the capacity to store fish. A fishing vest is usually made from durable, water-repellent material. The term "fishing vest" includes vests with flotation capacity, but not vests that are intended solely as flotation devices.

(G) *Landing nets*. A landing net consists of a handle connected to a hoop that is covered by a bag-type net. A landing net is primarily designed for scooping fish out of the water and onto shore, into a vessel, or onto any structure. Any fishing net is taxable as a landing net if it can be used as a landing net and if it incorporates in its design the three major components of a landing net—a handle, a hoop, and a bag-type net. A landing net may have a telescoping handle or may be made of material that floats.

(H) *Gaff hooks*. A gaff hook consists of a handle and a hook. A gaff hook is primarily designed for holding or lifting fish onto shore, into a vessel, or onto any structure once a fish is brought to the shore, boat, or structure on the end of a fishing line. A gaff hook can be made of any material and can be any size. The hook on a gaff hook may or may not be barbed. The term "gaff hook" includes, but is not limited to, straight or fixed-head gaffs, flying gaffs, and tuna hooks.

(I) *Fishing hook disgorgers*. A fishing hook disgorger is any implement designed to remove fishing hooks from the mouth, gill, arches, or stomach of fish. A fishing hook disgorger can be made of any material. Pliers are not considered fishing hook disgorgers for purposes of this section.

(J) *Dressing for fishing lines and artificial flies*. A dressing for fishing lines or artificial flies is any substance designed to be applied to a fishing line or an artificial fly to enhance the flotation of the line or fly or that is otherwise designed to attract fish to the artificial fly.

(7) *Fishing tip-ups and tilts*. A fishing tip-up or tilt is a device used in ice fishing that is designed to alert the person fishing that a fish is hooked, in the process of attempting to eat bait on a hook, or in the process of attempting to bite a bait or lure. A fishing tip-up or tilt consists of parts such as a spool on a spindle and a spring-mounted flag on opposite ends of a vertical pole or arm, with cross members to support the pole or arm over a hole in the ice. A fishing tip-up or tilt need not have a spring-mounted flag to be considered taxable under this section.

(8) *Fishing rod belts*. A fishing rod belt is an article that fastens around or near the waist of the person fishing. It is designed for holding the butt end of a rod or pole in a cup-like depression to aid in the handling of the rod or reel. A gimbal belt is an example of a fishing rod belt.

(9) *Fishing rod-holders*. A fishing rod-holder is a device that is portable and can be inserted into a beach, clamped onto a boat, or mounted onto any structure. A fishing rod-holder holds a rod or pole in a stationary position relative to the beach, boat, or structure. A storage rack for rods, generally known as a rod rack, is not considered a fishing rod-holder for this purpose.

(10) *Fishing harnesses*. A fishing harness is any article worn by an angler to transmit muscular power to the rod or to absorb strain. Fishing harnesses are usually made of canvas, leather, and/or similar materials, and have straps with devices that can be fastened to the reel and/or sockets into which the rod butt may be seated. A fighting chair harness is an example of a fishing harness.

(11) *Fish fighting chairs*. A fish fighting chair is a heavily built chair usually designed to have a footrest, rod holder, and swivel base attached. A fish fighting chair is usually permanently installed in a suitable fishing boat for the purpose of fighting deep sea fish with rod and reel. However, the chair may be mounted in the boat so as to be removable.

(12) *Fishing outriggers*. A fishing outrigger is a device, or pair of devices, attached to a boat, consisting of a braced rod or tube, with a means for attaching a fishing line out and away from the boat for trolling purposes. A fishing line is attached to a fishing outrigger in such a way that when a fish strikes the bait, the line is released from the outrigger so that the fish may be fought directly with rod and reel. A fishing outrigger can be of any size.

(13) *Fishing downriggers*. A fishing downrigger is a device used for submerging and lowering a fishing line and bait down and away from a boat while trolling. A downrigger usually consists of a boom and reel attached to the boat supporting a cable (downrigger line) and weight (sinker), with a means for attaching fishing line in such a way that when a fish strikes the trolled bait, the line is released from the weight so that the fish may be fought directly with rod and reel.

(14) *Electric outboard boat motors*. An electric outboard motor includes an electrically powered motor designed to be attached to the outer surface of a boat to facilitate the movement of the boat through the water.

(15) *Sonar devices suitable for finding fish*. A sonar device suitable for finding fish includes any such device except sonar devices that are graph recorders, digital type devices, and meter readout devices. Similarly, any combination sonar device that includes a graph recorder or meter readout is not taxable as an article of sport fishing equipment. Any other combination device is taxable.

Generally, articles of fishing equipment not specified in sections 4162(a) or 4152(b) of the Code are not subject to tax. Examples of such articles are: portable folding fishing chairs, rod-holders or fishwells designed for permanent installation, and fishing kites. Items of terminal tackle that may not be specifically enumerated in section 4162(a)(5) are subject to the tax.

The tax imposed by section 4161 of the Code applies only to articles of sport fishing equipment that are designed or constructed for use in the sport of fishing. Accordingly, the tax does not apply to those articles that, although nominally articles of sport fishing equipment, are in the nature of toys or novelties that merely simulate articles of sport fishing equipment, and are not designed or constructed for practical use in sport fishing. Except for items of terminal tackle designed for use and ordinarily used on fishing line over 130 pounds test, an article otherwise defined in this revenue ruling as an article of sport fishing equipment is subject to tax under section 4161 unless the taxpayer shows that the article is primarily designed for a purpose other than recreational fishing. If, however, such article as a practical matter can be used for recreational fishing as well as another purpose, the article is subject to tax under section 4161.

Section 4161(a) of the Code subjects to excise tax all parts and accessories for taxable sport fishing equipment that are sold on or in connection with the equipment, or in connection with its sale. The tax attaches in such cases whether or not charges for the parts or accessories are billed separately. To be considered a part or accessory for an article of sport fishing equipment specified in section 4162(a), an item must be either essential to the operation of the specified article, or be designed to improve its performance or appearance.

Chapter 33.—Facilities and Services
Subchapter B.—Communications

Section 4251.—Imposition of Tax

26 CFR 49.4251-1: Imposition of tax.
(Also Section 4252; 49.4252-1.)

Communications; leases; customer premises equipment. Lease payments for customer premises equipment used in connection with local telephone service are amounts paid for local telephone service and thus are subject to the tax imposed by section 4251(a)(1) of the Code, even though those payments are made to a lessor that does not otherwise provide access to a local telecommunications system.

Rev. Rul. 88-5

ISSUE

Does the communications excise tax imposed by section 4251(a)(1) of the Internal Revenue Code apply to lease payments for customer premises equipment (CPE) that is used in connection with local telephone service, if the payments are made to a lessor that does not otherwise provide access to a local telecommunications system?

FACTS

A vendor that is not otherwise engaged in providing access to a local telecommunications system leases CPE to residential and business customers. CPE is equipment (including mobile equipment) that is located on the customer's premises and is used wholly or in part for communications purposes. The customer uses the CPE in connection with local telephone service provided by a local telephone company that is unrelated to the vendor. None of the leased CPE is provided by the vendor in connection with the customer's nontaxable "private communication service" as defined in section 4252(d) of the Code.

LAW AND ANALYSIS

Section 4251(a)(1) of the Code imposes an excise tax on amounts paid for communications services. Those services, as enumerated in section 4251(b)(1), are: local telephone service, toll telephone service, and teletypewriter exchange service.

Section 4252(a) of the Code defines "local telephone service" as:

> (1) the access to a local telephone system, and the privilege of telephonic quality communication with substantially all persons having telephone or radio telephone stations constituting a part of such local telephone system, and
> (2) any facility or service provided in connection with a service described in paragraph (1).
>
> The term "local telephone service" does not include any service which is a "toll telephone service" or a "private communication service" as defined in subsections (b) and (d) of section 4252.

The recurring payments for CPE in the present situation are not for a "toll telephone service" as that term is defined in section 4252(b) of the Code or a "private communication service" as that term is defined in section 4252(d). However, the question remains whether leased CPE constitutes a "facility" provided in connection with access to a local telephone system and the privilege of telephonic quality communication with substantially all persons having telephone or radio telephone stations constituting a part of such local telephone system.

The Facilities and Services Excise Tax Regulations predate the statutory use of, and hence do not define, the term "local telephone service." However, section 49.4252-1 of the regulations does define the term "general telephone service," a term that was replaced in sections 4251 and 4252 with the term "local telephone service" by the Excise Tax Reduction Act of 1965, 1965-2 C.B. 568.

The legislative history of the Excise Tax Reduction Act of 1965 states that the term "local telephone service" was adopted in place of "general telephone service" and other changes in the wording of section 4252 of the Code were made in order:

> to make it clear that it is the service as such which is being taxed and not merely the equipment being supplied. Thus, in the case of local telephone service, the definition makes it clear that it is the right of access to a local telephone system and the privilege of telephonic quality communication which is taxed together with facilities or services provided with this service.

H.R. Rep. No. 433, 89th Cong., 1st Sess. 30 (1965), 1965-2 C.B. 643, 665; S. Rep. No. 324, 89th Cong., 1st Sess. 35 (1965), 1965-2 C.B. 676, 704.

In interpreting the term "general telephone services," section 49.4252-1(b)(5) of the regulations provides as follows:

> In cases where a person leases line or channels, equipment, and other facilities used in conjunction with general telephone service, the amounts paid by such person for such lines or channels, equipment, and other facilities constitute amounts paid for general telephone service, notwithstanding the fact that the lines or channels, equipment, and other facilities used in conjunction with such service are supplied by different persons or in part by the user of such service.

Thus, this regulation indicates that "equipment" such as CPE is a specific "facility" among "other facilities" expressly referenced therein. Further, the regulation provides that amounts paid for such equipment constitute amounts paid for "general telephone service" even though such equipment is supplied by a person other than the person supplying the exchange connection.

Although the 1965 amendments to section 4252 of the Code clarified that payments for telephone access "and not merely" payments for telephone equipment were included in the tax base, payments for the provision of equipment were not removed from the tax base. Moreover, there was no indication of Congressional intent to change the rule in the regulations that payments for "facilities used in conjunction with" telephone services are taxable even when those facilities "are supplied by different persons."

The above interpretation is consistent with the result reached on similar facts in *Situation 1* of Rev. Rul. 73-401, 1973-2 C.B. 363, modified by Rev. Rul. 86-36, 1986-1 C.B. 325. In Rev. Rul. 73-401, a lessee used communications equipment in connection with a taxable local telephone service. The lessor of the equipment was not otherwise engaged in furnishing communications services. The ruling holds that the lease payments for the communications equipment are amounts paid for equipment provided in connection with a taxable communications service and, therefore, the tax imposed by section 4251(a)(1) of the Code applies to amounts paid for the use of that equipment.

Rev. Rul. 86-36 does not require a different result here. That ruling held that the Internal Revenue Service will follow the decision in *Trans-Lux Corporation v. United States*, 696 F. 2d 963 (Fed. Cir. 1982). *Trans-Lux* held that rental payments for the lease of a teletypewriter terminal are not subject to the federal communications tax on teletypewriter exchange service. Regardless whether the lessor of the terminals also provides a teletypewriter exchange service, the rental payments are not subject to the tax because the lease of a teletypewriter terminal does not provide either access to a teletypewriter exchange system or the privilege of intercommunication with all persons constituting a part of the same teletypewriter exchange system. The rationale of that holding is not applicable here. Unlike the definition of "local telephone service" in section 4252(a) of the Code, the definition of "teletypewriter exchange service" in section 4252(c) refers only to "access. . .and the privilege of intercommunication" and not to "any facility. . .provided in connection with" that access or privilege.

Accordingly, CPE is a taxable "facility" and, to be taxed, that facility need not be provided by the same entity providing the service described in section 4252(a)(1) of the Code. To fall within the meaning of the term "local telephone service," the facility need only be provided "in connection with" the service described in section 4252(a)(1).

HOLDING

The lease payments for CPE used in connection with local telephone service are amounts paid for local telephone service under section 4252(a) of the Code, and thus are subject to the tax imposed by section 4251(a)(1), even though those payments are made to a lessor that does not otherwise provide access to a local telecommunications system.

Section 4252.—Definitions

26 CFR 49.4252-1: General telephone service.

Whether the communications excise tax imposed by section 4251(a)(1) of the Code applies to lease payments for customer premises equipment that is used in connection with local telephone service, if the payments are made to a lessor that does not otherwise provide access to a local telecommunications system. See Rev Rul. 88-5, page 359.

Chapter 36.—Certain Other Excise Taxes
Subchapter D.—Tax on Use of Certain Vehicles

Section 4481.—Imposition of Tax

26 CFR 41.4481: Imposition of tax.

T.D. 8177

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER D, PART 41—EXCISE TAX ON USE OF CERTAIN HIGHWAY MOTOR VEHICLES

Reduction of Heavy Vehicle Use Tax for Foreign-Based Vehicles

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the imposition of the heavy vehicle use tax on foreign-based highway motor vehicles. Changes to the applicable law were made by the Surface Transportation and Uniform Relocation Assistance Act of 1987. The regulations affect owners of highway motor vehicles that have a base for registration purposes in a contiguous foreign country and provide them with the guidance needed to comply with the law.

DATES: The regulations are effective for taxable periods beginning after June 30, 1987.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On September 4, 1987, the Federal Register published a notice of proposed rulemaking proposing amendments to the Excise Tax Regulations (26 CFR Part 41) under sections 4481, 4483, 6001, and 6091 of the Internal Revenue Code of 1986 (Code) (52 FR 33602) by cross-reference to temporary regulations published the same day in the Federal Register (52 FR 33583). These amendments were proposed to conform the regulations to section 507 of the Highway Revenue Act of 1987 (Title V of the Surface Transportation and Uniform Relocation Assistance Act of 1987) (Pub. L. 100-17, 101 Stat. 260) which imposed the heavy vehicle use tax under section 4481 of the Code on foreign-based highway motor vehicles. The Internal Revenue Service did not receive any comments on the proposed regulations. No public hearing was requested or held. For this reason, the final regulations adopt the temporary regulations without any substantive changes.

SPECIAL ANALYSIS

It has been determined that this regulation will not have a significant impact on a substantial number of small entities. The number of small entities affected is minimal. Accordingly, these final regulations are not subject to the Regulatory Flexibility Act of 1980 (5 U.S.C. Chapter 6). The Commissioner of Internal Revenue has determined that this regulation is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

PAPERWORK REDUCTION ACT

The collection of information requirements contained in these regulations have been submitted to the Office of Management and Budget (OMB) for review under the Paperwork Reduction Act of 1980. These regulations have been approved by OMB.

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 41 is amended as follows:

Paragraph 1. The authority for Part 41 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. *** Section 41.6001-3 also issued under 101 Stat. 260.

Par. 2. Section 41.4481-1 is amended by substituting "1993" for "1988" every place it appears and by revising paragraph (a)(2) to read as set forth below:

§41.4481-1 Imposition of tax.

(a)*In general.* ***

(2) (i) For taxable periods beginning after June 30, 1985, and before July 1, 1987, any highway motor vehicle that is issued a base plate by a Canadian province under the International Registration Plan (IRP) or similar agreement and has a proportional registration under such agreement to satisfy the registration laws of any of the United States shall be exempt from the tax imposed by section 4481(a).

(ii) For each taxable period beginning after June 30, 1987, the tax imposed by section 4481(a) shall apply to any highway motor vehicle that has a base for registration purposes in a contiguous foreign country upon the first use of such vehicle on the public highways in the United States during such period. See §41.4483-7 relating to a reduction of the tax in the case of a highway motor vehicle that has a base for registration purposes in a contiguous foreign country.

* * * * *

Par. 3. Section 41.4481-3 is amended by revising the first sentence of paragraph (a) to read as set forth below:

§41.4481-3 Registration.

(a) For purposes of the regulations in this part, the term "registered" when used in reference to a highway motor vehicle means—

(1) Registered under the law of any State or Territory of the United States, the District of Columbia, or contiguous foreign country, or

(2) Required to be registered under the law of any State or Territory of the United States or contiguous foreign country in which such highway motor vehicle is operated or situated or, in case the vehicle is operated or situated in the District of Columbia, under the law of the District of Columbia.

* * * * *

Par. 4. Section 41.4482(c)-1 is amended by substituting "1993" for "1988" every place it appears in paragraph (b).

Par. 5. Section 41.4483-5 is amended by substituting "1993" for "1988" where it appears.

Par. 6. A new §41.4483-7 is added immediately after §41.4483-6 to read as follows:

§41.4483-7 Reduction in tax for vehicles registered in a contiguous foreign country.

(a) *In general.* In the case of a highway motor vehicle that, for any taxable period, has a base for registration purposes in a contiguous foreign country, the tax imposed by section 4481 for such taxable period shall be 75 percent of the tax that would be imposed but for this section. A highway motor vehicle has a base for registration purposes in a contiguous foreign country in any taxable period in which such vehicle is registered under the laws of a contiguous foreign country and such vehicle is not registered under the laws of any of the United States other than proportionately registered under a proration agreement (such as the International Registration Plan). A highway motor vehicle is not considered to have a base for registration purposes in a contiguous foreign country in any taxable period in which such vehicle is registered under the laws of any of the United States and such State is required under §41.6001-2(b) to receive proof of payment of the tax imposed by section 4481(a) with respect to such highway motor vehicle. For purposes of this paragraph (a), a highway motor vehicle that is allowed to operate in a State under a reciprocity agreement is not considered to be registered under the laws of that State.

(b) *Contiguous foreign country.* The term "contiguous foreign country" means Canada or Mexico.

Par. 7. A new §41.6001-3 is added immediately after §41.6001-2 to read as follows:

§41.6001-3 Proof of payment for entry into the United States.

(a) *In general.* (1) Except as otherwise provided in paragraph (a)(2) of this section, proof of payment of the tax imposed by section 4481(a) must be presented to United States Customs officials with respect to any highway motor vehicle subject to the tax imposed by section 4481(a) that has a base for registration purposes in a contiguous foreign country upon entry of such vehicle into the United States during any taxable period to which this section applies. Such proof of payment must relate to tax paid (or suspended under §41.4483-3) for the taxable period that includes the date of entry into the United States. See paragraph (c) of this section for the definition of the term "proof of payment."

(2) No proof of payment is required upon entry of a highway motor vehicle described in paragraph (a)(1) of this section into the United States if, as of the date of such entry, the period of time for filing a return of the tax imposed on such vehicle by section 4481(a) for the taxable period that includes the date of such entry has not expired and a written declaration is presented to United States Customs officials. Such declaration must state that, as of the date of such entry, the period of time for filing a return of the tax imposed on such vehicle by section 4481(a) for the taxable period that includes the date of such entry has not expired. The written declaration must include (1) the name, address, and taxpayer identification number of the person liable under §41.4481-2 for the tax imposed on such vehicle; (2) the vehicle identification number of such vehicle; (3) the date on which such vehicle was first used on the public highways in the United States during the taxable period (or a statement that the current entry is the first use on the public highways in the United States during the taxable period); (4) an acknowledgement by the person liable for the tax imposed on such vehicle that the willful use of the declaration to evade or defeat the tax otherwise applicable under section 4481(a) will subject such person to a fine or imprisonment or both; and (5) the signature of the person liable for the tax imposed on such vehicle. A copy of the written declaration shall be retained in the records of the person liable for the tax imposed on such vehicle under the rules of §41.6001-1. See §41.6071(a)-1 for rules regarding the time for filing a return of the tax imposed by section 4481(a).

(b) *Failure to provide proof of payment.* If, upon attempting to enter the United States, the operator of a highway motor vehicle described in paragraph (1) of this section is unable to present proof of payment of the tax imposed by section 4481(a), or documentation described in paragraph (a)(2) of this section, with respect to such vehicle, then such vehicle may be denied entry into the United States.

(c) *Proof of payment*—(1) *In general.* For purposes of this section, the proof of payment required in paragraph (a) of this section shall consist of a receipted Schedule 1 (Form 2290) that is returned by the Internal Revenue Service to a taxpayer that files a return of tax under section 4481(a) and pays the amount of tax (or installment thereof) due with such return. A photocopy of such receipted Schedule 1 shall also serve as proof of payment. Such proof of payment shall also serve as proof of suspension of the tax under §41.4483-3 for the number of vehicles entered in that part of the Schedule 1 designated for vehicles for which tax has been suspended. The vehicle identification number of any vehicle for which a return is being filed, whether tax is being paid with respect to such vehicle or tax is suspended on such vehicle, must appear on the Schedule 1 (or an attached page) in order for the Schedule 1 to be a valid proof of payment for such vehicle.

(2) *Acceptable substitute for receipted Schedule 1.* For purposes of this section, a photocopy of the Form 2290 (with the Schedule 1 attached) that is filed with the Internal Revenue Service for a vehicle being entered into the United States with sufficient documentation of payment of tax due at the time the Form 2290 is filed (such as a photocopy of both sides of a cancelled check) shall be accepted as proof of payment. No documentation of payment of tax is required with the substitute proof of payment if at the time the Form 2290 is filed the tax imposed by section 4481(a) is suspended under §41.4483-3 with respect to the vehicle entering the United States. This substitute proof of payment may be used to enter a vehicle into the United States when, for example, the receipted Schedule 1 has been lost, or if the taxpayer that filed a Form 2290 with respect to such vehicle has not received a receipted Schedule 1 at the time such vehicle enters the United States.

(d) *Taxable periods to which this section applies.* This section shall apply to any taxable period beginning on or after July 1, 1987.

Par. 8. Section 41.6091-1 is amended as follows:

(a) The second sentence of paragraph (a) is revised to read as set forth below.

(b) The second sentence of paragraph (b) is revised to read as set forth below.

§41.6091-1 Place for filing returns.

(a) *** If the person has no principal place of business or legal residence in any internal revenue district, the return shall be filed with the Internal Revenue Service Center, Philadelphia, PA.

(b) *** If a corporation has no principal place of business or principal office or agency in any internal revenue district, the return shall be filed with the Internal Revenue Service Center, Philadelphia, PA.

Par. 9. The authority for 26 CFR Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 10. Section 602.101(c) is amended by inserting the following item in the appropriate place in the table:

"§41.6001-3 .... 1545-0143"

* * * * *

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved February 9, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 1, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 2, 1988, 53 F.R. 6625)

Chapter 44.—Qualified Investment Entities

Section 4981.—Excise Tax on Undistributed Income of Real Estate Investment Trusts

26 CFR 55.4981-1: Imposition of excise tax on certain real estate investment trust taxable income not distributed during the taxable year

T.D. 8180

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, SUBCHAPTER D, SUBCHAPTER H, PART 5h—TEMPORARY REGULATIONS—ELECTIONS UNDER VARIOUS PUBLIC LAWS; PART 55—EXCISE TAX ON CERTAIN REAL ESTATE INVESTMENT TRUSTS; PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Excise Taxes Relating to Real Estate Investment Trusts and Regulated Investment Companies

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations and temporary regulations.

SUMMARY: This document contains final and temporary regulations under the Internal Revenue Code relating to the manner and method of reporting and paying the 4% excise tax imposed on real estate investment trusts (REITs) and regulated investment companies (RICs). These excise taxes were added to the Internal Revenue Code by the Tax Reform Act of 1986. The final regulations provide REITs and RICs with the guidance necessary to comply with the reporting requirements for these new excise taxes. The amendment to the temporary regulations relates to certain elections by RICs under the Tax Reform Act of 1986.

EFFECTIVE DATE: January 1, 1987.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains final amendments to the Excise Tax Regulations (26 CFR Part 55) under chapter 44 of the Internal Revenue Code of 1986. These amendments provide guidance for the proper manner and method of reporting and paying the 4% excise tax imposed on REITs and RICs. The regulations reflect the amendment to section 4981 by section 668 of the Tax Reform Act of 1986 ("Act") (Pub. L. No. 99-514, 100 Stat. 2085)[1986-3 (Vol. 1) C.B. 1, 223] and the addition of section 4982 by section 651 of the Act. This document also contains an amendment to the temporary regulations relating to certain elections under the Act (26 CFR §5h.5). T.D. 8124 [1987-1 C.B. 353], which added 26 CFR §5h.5, was published in the Federal Register (52 FR 3623) on February 5, 1987. The amendment to the temporary regulations relates to the time for making the election available to RICs under section 4982(e)(4). These amendments were published in proposed form in the FEDERAL REGISTER on September 9, 1987 (52 FR 33953) [1987-2 C.B. 1033]. There was no public hearing regarding the proposed amendments, and there were no written comments regarding the proposed amendments. Therefore, the amendments, as proposed, are adopted by this Treasury Decision.

EXPLANATION OF PROVISIONS
EXCISE TAX PROCEDURES

Section 4981 imposes a nondeductible excise tax on any REIT. Such excise tax is equal to 4% of the excess, if any, of the required distribution for any calendar year over the distributed amount for such calendar year. New section 4982 imposes a similar nondeductible 4% excise tax on RICs. In general, these provisions require a REIT or a RIC to distribute an amount equal to the sum of specified percentages of its ordinary income and capital gain net income to its shareholders prior to the end of any calendar year in order to avoid the excise tax liability. Amounts not required to be distributed currently must be distributed before the end of the following calendar year.

The regulations prescribe the manner and method of paying the excise taxes imposed under sections 4981 and 4982. If a REIT is liable for the excise tax imposed by section 4981, such tax must be reported on Form 8612. A RIC which is liable for the excise tax imposed by section 4982 must report such tax on Form 8613. The excise tax return must be filed on or before March 15 of the first calendar year subsequent to the calendar year to which the excise tax liability applies. Full payment of the excise tax liability must accompany the excise tax return. The excise tax return, together with the payment satisfying such excise tax, are to be filed at the place specified in the existing regulations under Part 55. District directors and directors of service centers have the discretion to grant extensions of time for filing the excise tax return of up to six months. However, an extension of time for filing the excise tax return generally shall not operate to extend the time for the payment of the excise tax or any part thereof. Thus, payment satisfying the excise tax liability must still be made on or before the prescribed due date for the excise tax return, *i.e.*, March 15.

Section 4981, as in effect prior to the amendments made by the Act, imposed an excise tax on the undistributed income of a REIT determined on the basis of the REIT's taxable year. The amendments made to section 4981 by the Act impose an excise tax on the undistributed income of a REIT determined on the basis of a calendar year, effective for calendar years after 1986. The regulations interpret the amendments made to section 4981 by the Act so that a REIT with a taxable year ending after December 31, 1986, will not be liable for the excise tax under the pre-Act version of section 4981 for that year.

The regulations do not address the determination of the proper amount of the excise tax imposed by sections 4981 and 4982. Any issues related to such determination that may be appropriately addressed by regulations will be considered when regulations are developed to reflect other amendments to the REIT and RIC provisions made by the Tax Reform Act of 1986.

SECTION 4982(e)(4) ELECTION

Section 4982(e)(4) allows a RIC to elect to use the period ending November 30 or December 31 for purposes of computing capital gain net income under section 4982 if that date corresponds to the end of the RIC's taxable year. Once an election under section 4982(e)(4) has been made by a RIC, the election can only be revoked with the consent of the Secretary. Section 5h.5(a)(2)(vi) of Title 26 of the Code of Federal Regulations provides that the election under section 4982(e)(4) is to be made on the excise tax return for RICs (Form 8613) and that the election must be made on or before March 15 of the first calendar year beginning after the end of the first excise tax period for which the election is to be effective. Because RICs must also use Form 8613 to report and pay the excise tax imposed under section 4982, and because RICs are permitted to request an extension of time to file Form 8613, the amendment to §5h.5(a)(2)(vi) permits an extension of time for making the election under section 4982(e)(4) in those situations where a RIC is granted an extension of time to file Form 8613.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis therefore is not required. Although a notice of proposed rulemaking that solicited public comment was issued, the Internal Revenue Service concluded when the notice was issued that the notice and public procedure requirements of 5 U.S.C. 553 do not apply because the rules provided herein are interpretative. Accordingly, these final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The collections of information contained in these regulations have been submitted to the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1980. The requirements have been approved by OMB under control number 1545-0999.

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Parts 5h, 55, and 602 are amended as follows:

Paragraph 1. The authority for Part 5h continues to read in part as follows:

Authority: 26 U.S.C. 7805. *** Section 5h.5 also issued under 26 U.S.C. 4982(e)(4).

Par. 2. Section 5h.5(a)(2)(vi) is revised to read as follows:

§5h.5 Time and manner of making the elections under the Tax Reform Act of 1986—(a) *Miscellaneous elections* ***

(2) *Time for making elections.* ***(vi) *Time for making certain elections by regulated investment companies.* The election under Act section 651 (Code section 4982(e)(4)) shall be made on a statement attached to the form prescribed by the Internal Revenue Service which is used to report and pay the excise tax liability under section 4982. The election shall be filed on or before the later of—

(A) March 15 of the first calendar year beginning after the end of the first excise tax period for which the election is to be effective, or

(B) If the regulated investment company has been granted an extension of time to file a return for the excise tax under Code section 4982 for such excise tax period, the due date (including extensions thereof) for such return.

The statement of election under section 4982(e)(4) shall be attached to the prescribed form regardless of whether the regulated investment company is liable for the excise tax imposed by section 4982 for the excise tax period in question.

* * * * *

Par. 3. The authority for Part 55 is revised to read as follows:

Authority: 26 U.S.C. 7805. *** Section 55.6011-1 also issued under 26 U.S.C. 6011(a). *** Section 55.6071-1 also issued under 26 U.S.C. 6071(a). *** Section 55.6091-1 also issued under 26 U.S.C. 6091(a). *** Section 55.6151-1 also issued under 26 U.S.C. 6151.

Par. 4. The title of Part 55 is revised to read as follows:

Excise tax on real estate investment trusts and regulated investment companies.

Par. 5. The title to Subpart A of Part 55 is revised to read as follows:

SUBPART A—Excise Tax On Real Estate Investment Trusts.

Par. 6. The heading of §55.4981-1 is revised to read as follows:

§55.4981-1 Imposition of excise tax on certain real estate investment trust taxable income not distributed during the taxable year; taxable years ending on or before January 1, 1987.

Par. 7. Section 55.4981-1 is amended by:

(1) Inserting the words ", as in effect before amendment by the Tax Reform Act of 1986," immediately following the words "Section 4981" and "section 4981" wherever those words appear, and

(2) inserting "and ending before January 1, 1987," immediately after "1979," in the last sentence.

Par. 8. A new §55.4981-2 is added immediately after §55.4981-11 to read as follows:

§55.4981-2 Imposition of excise tax with respect to certain undistributed income of real estate investment trusts; calendar years beginning after December 31, 1986. Section 4981, as amended by the

Tax Reform Act of 1986, imposes an excise tax on a real estate investment trust in the amount of four percent of the excess, if any, of the required distribution for a calendar year over the distributed amount for such calendar year. Section 4981, as so amended, applies only to calendar years that begin after December 31, 1986. For provisions relating to the imposition of an excise tax with respect to certain undistributed income of real estate investment trusts for taxable years ending before January 1, 1987, see §55.4981-1.

Par. 9. "Subpart B—Procedure and Administration" is retitled

"Subpart C—Procedure and Administration".

Par. 10. A new subpart B is added to read as follows:

SUBPART B—Excise Tax on Regulated Investment Companies.

§55.4982-1 Imposition of excise tax on undistributed income of regulated investment companies.

Section 4982 imposes an excise tax on a regulated investment company in the amount of four percent of the excess, if any, of the required distribution for a calendar year over the distributed amount for such calendar year. Section 4982 applies only to calendar years beginning after December 31, 1986.

Par. 11. Section §55.6011-1 is revised to read as follows:

§55.6011-1 General requirement of return, statement, or list.

Every person liable for tax under Chapter 44 shall file an annual return with respect to the tax on the form prescribed by the Internal Revenue Service for such purpose and shall include therein the information required by the form and the instructions issued with respect thereto. For calendar years beginning after December 31, 1986, the return, which must be made on a calendar year basis, shall be filed by a real estate investment trust on Form 8612 and by a regulated investment company on Form 8613.

Par. 12. Section 55.6061-1 is revised to read as follows:

§55.6061-1 Signing of returns and other documents.

Any return required to be made by a real estate investment trust or a regulated investment company with respect to the tax imposed by chapter 44 shall be signed by a person authorized by section 6062 of the Code to sign the income tax return of the real estate investment trust or the regulated investment company. Any statement or other document required to be made with respect to the tax imposed by chapter 44 shall be signed by the person required or duly authorized to sign in accordance with the regulations, forms, or instructions prescribed with respect to such statement or document. An individual's signature on a return, statement, or other document made by or for the real estate investment trust or the regulated investment company shall be prima facie evidence that the individual is authorized to sign the return, statement, or other document.

Par. 13. Section 55.6071-1 is revised to read as follows:

§55.6071-1 Time for filing returns.

(a) *Returns for calendar years beginning after December 31, 1986.* A return required by §55.6011-1 for any calendar year beginning after December 31, 1986, shall be filed on or before March 15 of the following calendar year. See §§55.6081-1 for rules relating to extensions of time for filing a return required by §55.6011-1.

(b) *Returns for excise tax under section 4981 as in effect before amendment by the Tax Reform Act of 1986.* A return required by §55.6011-1 for any excise tax under section 4981, as in effect before amendment by the Tax Reform Act of 1986, shall be filed at the time (including any extension of time granted or allowed under section 6081) that the real estate investment trust is required to file its income tax return under section 6012 for the taxable year for which the tax under section 4981, as in effect before amendment by the Tax Reform Act of 1986, is imposed.

Par. 14. Section 55.6091-1(a) is amended by adding the words "or regulated investment company" immediately after the words "real estate investment trust".

Par. 15. A new §55.6151-1 is added to read as follows:

§55.6151-1 Time and place for paying of tax shown on returns.

The tax shown on any return which is imposed by Chapter 44 shall, without notice or assessment and demand, be paid to the internal revenue officer with whom the return is filed at the time and place for filing such return (determined without regard to any extension of time for filing the return). For provisions relating at the time and place for filing such return, see §§55.6071-1 and 55.6091-1. For provisions relating to the extension of time for paying the tax, see §55.6161-1.

Par. 16. The authority citation of 26 CFR Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 17. Section 602.101(c) is amended by inserting in the appropriate place in the table:

§5h.5(a)(2)(vi)	1545-0999
§55.6011-1	1545-0999
§55.6061-1	1545-0999
§55.6071-1	1545-0999

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved February 9, 1988.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the office of the Federal Register on February 29, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 1, 1988, 53 F.R. 6146).

Section 4981A.—Tax on Excess Distributions From Qualified Retirement Plans.

26 CFR 54.4981A-1T: Tax on excess distributions and excess accumulations.

T.D. 8165

TITLE 26.—INTERNAL REVENUE, CHAPTER I, SUBCHAPTER D, SUBCHAPTER H, PART 54—PENSION EXCISE TAXES PART 602—OMB CONTROL NUMBERS UNDER PAPERWORK REDUCTION ACT

Excise Tax on Excess Distributions From Retirement Plans

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to excess distributions from qualified plans, individual retirement plans, and section 403(b) annuity contracts, custodial accounts, and retirement income accounts. Changes to the applicable law were made by the Tax Reform Act of 1986 [1986-3 C.B. (Vol. 1) 1]. These regulations will affect administrators of, participants in, and beneficiaries of qualified pension, etc. plans; institutions that sponsor and individuals who administer individual retirement plans, indi-

viduals who use individual retirement plans and simplified employee pensions for retirement income and beneficiaries of individual retirement plans; and employees for whom amounts are contributed to section 403(b) annuity contracts, custodial accounts, or retirement income accounts and beneficiaries of such contracts and accounts. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations for the notice of proposed rulemaking *** [page 880, this Bulletin.]

DATES: The regulations generally apply to calendar years beginning after December 31, 1986, except as otherwise specified in the Act.

SUMMPLEMENTARY INFORMATION:

BACKGROUND

This document amends the Pension Excise Tax Regulations (26 CFR Part 54) to provide temporary rules under section 4981A of the Internal Revenue Code of 1986. The temporary regulations reflect the addition of section 4981A to the Code by section 1133 of the Tax Reform Act of 1986 (1986 Act) (100 Stat. 2481) [1986–3 C.B. (Vol. 1) 1, 398].

DESCRIPTION OF EXCESS DISTRIBUTION RULES OVERVIEW

The 1986 Act provides for a new excise tax under section 4981A on excess distributions from qualified retirement plans and tax-sheltered annuities (qualified employer plans) and individual retirement accounts (IRAs).

To the extent that during any calendar year annual distributions for an individual from qualified employer plans and IRAs exceed a threshold amount, the 1986 Act generally imposes an excise tax equal to 15 percent of this excess. If the individual is also liable for the 10-percent tax on early distributions under section 72(t) (also added by the 1986 Act), this new excise tax on the excess distributions may be reduced by the 10-percent income tax on early distributions. Not every distribution from these plans and IRAs is subject to the 15-percent excise tax. The provision allows reduction for specific itemized exceptions and also allows a reduction for pre-existing accrued benefits as of August 1, 1986. These reductions are discussed below. The 1986 Act also imposes an excise tax equal to 15 percent of the decedent's benefits that are held under qualified employer plans and IRAs on the date of death. This excise tax on death is treated as an additional tax imposed under the estate tax provisions. In general, this excise tax is an additional estate tax and the calculation of this excise tax is independent of the calculation of the estate tax owed upon death.

TAX ON LIFETIME DISTRIBUTIONS

Section 4981A of the Internal Revenue Code (Code) imposes an excise tax on an individual who receives "excess distributions" from qualified employer plans and IRAs. Excess distributions are defined in section 4981A(c)(1) as the total amount of distributions during any calendar year to the extent that such amounts exceed either $112,500 (adjusted for cost-of-living increases (COLAs)) or $150,000. The plan or IRA need not be tax-qualified at the time of the distributions if it previously received the benefits of tax-qualified status. Not all distributions from these plans or IRAs are subject to the excise tax. Section 4981A lists various exclusions. Among these exclusions are distributions made after the individual's death (these distributions are subject to the excise tax on death); payments made to a spouse or former spouse pursuant to a qualified domestic relations order that are includible in the income of such spouse; tax-free distributions attributable to the individual's investment under the plan or IRA (e.g., after-tax employee contributions, loan amounts previously includible in the individual's income, etc.); and distributions to the individual that are not includible in gross income because the individual makes a qualifying rollover (e.g., a rollover to an IRA or qualified retirement plan permitted by Code sections 402(a)(5), 403(a)(4), 403(b)(8), 405(d)(3) or 408(d)(3)). Additionally, the regulations provide for exclusion of medical benefits and health coverage provided under an arrangement described in section 401(h) that are excludible from income under section 104, 105, or 106. Distributions to a spouse, as described above, are distributions to such spouse for purposes of calculating the spouse's tax under this provision.

Section 54.4981A–1T a. General Provisions and Excess Distributions, Q&A a–1 through a–9, discusses how this excise tax is computed in the case of these lifetime distributions.

SPECIAL GRANDFATHER RULE

Section 4981A(c)(5) allows an individual to elect a special rule to calculate the individual's tax under this new provision. In order to be eligible for this special calculation, the individual must have benefits under these plans and IRAs whose present value equals at least $562,500 as of August 1, 1986 (grandfather amount). If this special rule is elected, the individual's distributions are offset by the grandfather amount in a manner specified under these regulations over the individual's lifetime, and upon death in the case of an outstanding grandfather amount. The grandfather benefits are not specifically allocated to individual plans but rather offset all distributions that are subject to the new tax. The regulations provide methods for calculating these grandfathered benefits. The calculation of benefits as of August 1, 1986 is done by plan administrators or trustees who hold benefits under these plans or IRAs. The rules provide an alternative simplified method for calculating the grandfather amount. Generally, the amount of such benefits is furnished to the individual upon the individual's request and is then used to substantiate the individual's (or the estate's) calculation of the excise tax for all years that the individual has remaining assets in all retirement plans and IRAs, including one for which the individual has no grandfather benefit.

The regulations provide rules as to the rate at which the grandfathered benefit is recovered (See Q&A b–11 through 14 of §54.4981A–1T). In order to use this special tax calculation under the grandfather rule, an individual must elect in a manner specified under the regulations. Also, the individual must choose between two alternative methods for recovering the grandfather amount, the "discretionary method" or "the attained age method." Under either method, all distributions received between August 1 and December 31, 1986 are treated as grandfathered amounts.

Under the discretionary method, distributions after 1986 are treated as coming from grandfather amounts in an amount equal to 10 percent of the distributions. For any calendar year, the individual may elect to accelerate the 10-percent rate of grandfather recovery to 100 percent. If the individual elects this acceleration, the 100 percent rate applies to all distributions in the calendar year and, to the extent that there is a remaining grandfather amount, applies to subsequent years until the grandfather benefits are reduced to zero. This discretionary method is provided in the regulations because other methods considered would impose burdensome and complex recordkeeping on administrators of all qualified employer plans and IRAs under which the individual has benefits.

The other method, the attained age method, is only available to an individual who was 35 or older on August 1, 1986. Under this method the distributions that are received in a calendar year are treated as a recovery of the grandfather amount based on a formula that takes into account the individual's age on August 1, 1986 and the individual's age on the December 31 of the calendar year. In general, under this method the grandfather amount recovered diminishes as the individual ages.

Even though distributions that are treated as a recovery of a grandfather amount are not taxable, they are taken into account (by applying such amounts first against the threshold amount) in determining whether or not other distributions that the individual receives are subject to the excise tax. An individual who elects the special rule for the grandfather amount has a threshold amount that is limited to $112,500 (adjusted for COLAs) and may not use the $150,000 threshold amount. Thus, for example, an individual who recovers distributions under the 10-percent discretionary rule in calendar year 1987 and who receives a distribution of $150,000 in 1987 has $37,500 of distributions subject to the excise tax of 15 percent ($150,000 – $112,500). Because the portion of the distribution which is treated as the grandfather amount recovered of $15,000 (10% of $150,000) is less than the threshold amount of $112,500, the recovery of this grandfather amount does not affect the calculation of the 1987 excise tax.

ADDITIONAL EXCISE TAX UPON DEATH

Section 4981A(d) imposes a 15-percent tax on the individual's excess accumulation on the date of death. In general, accumulation is defined in the same manner as distributions except that there is no exclusion for distributions made after death and the imposition of the tax is not conditioned on receipt of a distribution. The excise tax on an excess accumulation is imposed by increasing the Chapter 11 (estate) tax otherwise due with respect to the individual's estate. The tax is payable under the rules governing the payment of estate tax, e.g., the tax is due 9 months after the date of death and is paid by the executor.

This 15-percent additional excise tax is unaffected by the normal estate tax calculation. Thus, no credits, deductions, exclusions or other special rules for determining the decedent's estate tax affect the calculation of the section 4981A(d) excise tax. For example, the 15-percent tax may apply even though there is no estate tax liability and a Form 706 would have to be filed only to report the excise tax.

The accumulation equals the value of the decedent's interest in all qualified retirement plans and IRAs on the date of death. Generally, these values are determined in the same manner that the value of such interest would be determined for purposes of the estate tax. If the estate is subject to estate tax, the alternate valuation date rules in section 2032 apply. In calculating the amount of the excess accumulation, the value of the decedent's interest in qualified employer plans and IRAs is taken into account regardless of the number of the decedent's beneficiaries. Life insurance proceeds excludible under section 101(a) are not subject to tax.

The calculation of this additional excise tax upon death is done in accordance with several special computational rules. First, an alternative threshold amount is used to determine the amount of the excess accumulation. The alternative threshold amount is based on a hypothetical single life annuity commencing as of the date of the decedent's death payable for the life of an individual whose age is the same as the age of the decedent (in whole years) as of the date of the decedent's death. The annual amount of such annuity used to determine the alternative threshold amount is the annual threshold amount ($150,000 or the applicable $112,500 adjusted for COLAs) in effect on the date of death.

Second, if the special grandfather rule applies and the decedent's remaining unrecovered grandfather amount exceeds the applicable alternative threshold amount, the excess accumulation is determined by reducing the decedent's accumulation by the decedent's remaining unrecovered grandfather amount rather than by the alternative threshold amount.

The excise tax on accumulations is in lieu of subjecting post-death distributions (including distributions of death benefits under these plans or IRAs) to the annual tax on excess distributions received by the decedent's beneficiaries. Thus, except in limited circumstances such as a decedent's spouse (or other individual permitted under prior law) treating a retirement plan or IRA as his own plan or IRA, the decedent's interest in such plan or IRA will not be subject to the tax on lifetime distributions when received by the decedent's beneficiary or beneficiaries.

REPORTING, RECORDKEEPING AND ELECTIONS GRANDFATHER AMOUNTS

An individual must make the special grandfather elections on the individual's income tax return for the 1987 or 1988 taxable year. In general, those elections become irrevocable upon the time for filing, with extensions, the return for the 1988 taxable year. If the individual is deceased, the personal representative of the individual may make such elections. The value of the grandfather amount is determined under the records furnished to the individual by the individuals responsible for administering the plans and IRAs. The individual must maintain these records, as well as a copy of the return under which the elections were made, to substantitate later recovery of grandfather amounts. The individual may not independently determine the value of the grandfather amount, as the grandfather amount may only be substantiated by records furnished the individual under the plans or IRAs for which the individual is claiming a grandfather amount. The regulations provide rules governing how the individual and the plan or IRA trustees or plan administrators must keep records, request information or furnish information concerning these grandfather amounts.

The individual in each taxable year that is subject to the new excise tax must furnish information concerning all distributions from qualified employer plans and IRAs with the individual's income tax return. The tax is reported on the Form 5329, Return for Individual Retirement Arrangement and Qualified Retirement Plans Taxes. The Form 5329 is presently being revised and will be available later this year. The tax is due at the time for filing the relevant income tax return in the same manner that income taxes would be due. Individuals who have no grandfather amount and receive distributions that are less than the threshold amount ($150,000 or $112,500 indexed) are not required to file the Form 5329 for the taxable year.

In general, comparable reporting rules apply to the excise tax on excess accumulations. Thus, the personal representative may elect the grandfather rule in the same manner that the individual may elect the rules. The executor of the estate of an individual who has an excess accumulation must file Schedule S (Form 706) with the applicable estate tax return of the individual. Thus, the excise tax is due when the estate tax (if any) would be due. The Schedule S (Form 706) and applicable instructions will provide more detail and rules as to the reporting of the excise tax under section 4981A.

OTHER SPECIAL RULES

The regulations provide special rules for (1) taxpayers who elect special tax treatment under sections 402 and 403 for lump sum distributions received in a taxable year (see Q&A c-1 of §54.4981A-1T); and (2) the offset of the excise tax on excess distributions by the 10-percent tax under section 72(t) on early distributions from qualified retirement plans (see Q&A c-4 of §54.4981A-1T).

EFFECTIVE DATE OF TAX

The excise tax is generally effective with respect to excess distributions received after December 31, 1986 (see Q&A c-6 of §54.4981A-1T). The additional excise tax on excess accumulations is effective for deaths occurring after December 31, 1986 (see Q&A d-11 of §54.4981A-1T).

ANTICIPATION OF TECHNICAL CORRECTIONS

H.R. 2636 and S. 1350, "the Technical Corrections Act of 1987" would provide numerous technical corrections to section 4981A, correcting and clarifying the rules contained therein. The rules adopted in the regulations anticipate the technical corrections that are arguably clarifying rather the correcting. The rules in the regulations that anticipate technical corrections are listed below:

a. Determination of excess contributions.

1. The regulations provide that the distribution of an annuity contract not currently includible in income in satisfaction of plan liabilities is disregarded for purposes of calculating excess distributions.

2. The regulations provide that distributions of certain excess deferrals and excess contributions are not taken into account in determining excess contributions.

b. Determination of excess accumulation.

1. The regulations provide that, in determining a decedent's aggregate interest for purposes of determining the tax on excess accumulations, certain benefits are excluded. Those benefits are benefits which generally parallel benefits which if distributed before death, would have been excluded in determining excess distributions. Those benefits also include life insurance proceeds excludible under section 101(a).

2. The regulations provide that no credits under section 2010 through 2016 or other reduction permitted by chapter 11 are allowable against the tax under section 4981A(d) for excess accumulations.

3. The regulations provide that excess accumulations are computed without regard to community property law.

4. The regulations provide that the alternate threshold amount used to determine excess accumulations is based on a hypothetical single life annuity for the life of an individual whose age is the same as the age of the decedent (in whole years) as of the decedent's date of death.

c. Application of the grandfather rule.

1. The regulations apply the grandfather rule at death in determining the amount of the tax on excess accumulations.

2. The regulations provide that certain benefits payable with respect to an individual are not taken into account in determining the amount grandfathered. These are benefits (*e.g.*, the individual's investment in the contract and benefits payable to certain alternate payees) that when distributed are excluded in determining the amount of excess distributions.

3. The regulations provide that the election of the grandfather rule must be made not later than the due date (with extensions) for filing the individual's 1988 income tax return.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The collection of information requirements contained in these regulations have been submitted to the Office of Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduction Act of 1980. These requirements have been approved by OMB under Control NO. 1545-0203.

* * * * *

Adoption of amendments to the Regulations

Accordingly, 26 CFR Parts 54 and 602 are amended as follows:

PENSION EXCISE TAX REGULATIONS (26 CFR Part 54)

Paragraph 1. The authority citation for Part 54 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. *** Section 54.4981A-1T is also issued under 26 U.S.C. 4981A.

Par. 2. There is added the following new section after §54.4978-1T to read as follows: §54.4981A-1T Tax on excess distributions and excess accumulations (Temporary).

The following questions and answers relate to the tax on excess distributions and excess accumulations under section 4981A of the Internal Revenue Code of 1986, as added by section 1133 of the Tax Reform Act of 1986 (Pub. L. 99-514)[1986-3 C.B. (Vol. 1),1, 398].

Tables of Contents

a. General Provisions and Excess Distributions.

b. Special Grandfather Rules.

c. Special Rules.

d. Excess Accumulations.

a. General Provisions and Excess Distributions.

a-1: Q. What changes were made by section 1133 of TRA '86 regarding excise taxes applicable to distributions from qualified employer plans and individual retirement plans?

A. Section 1133 of TRA '86 added section 4981A to the Code. Section 4981A imposes an excise tax of 15 percent on (a) excess distributions, as defined in section 4981A(c)(1) and Q&A a-2 of this section, and (b) excess accumulations, as defined in section 4981A(d)(3) and Q&A d-2 of this section. The excise tax on excess distributions generally applies to excess distributions made after December 31, 1986 (see Q&A c-6 of this section). The excise tax on excess accumulations applies to estates of decedents dying after December 31, 1986 (see Q&A d-11 of this section). Excess distributions are certain distributions from qualified employer plans and individual retirement plans. Excess accumulations are certain amounts held on the date of death of an employee or individual by qualified plans and individual retirement plans.

a-2: Q. How are excess distributions defined?

A. Excess distributions are generally defined as the excess of the aggregate amount of distributions received by or with respect to an individual during a calendar year over the greater of (a) $150,000 (unindexed) or (b) $112,500 (indexed as provided in Q&A a-9 of this section beginning in 1988 for cost-of-living increases). Certain individuals may elect to have the portion of their excess distributions that is subject to tax determined under a "special grandfather" rule that is described below (see Q&A b-1 through b-14 of this section).

a-3: Q. Distributions from what plans and arrangements are taken into account in applying section 4981A?

A. (a) *General rule.* Section 4981A applies to distributions under any qualified employer plan or individual retirement plan described in section 4981A(e). For this purpose, a qualified employer plan means any—

(1) Qualified pension, profit-sharing or stock bonus plan described in section 401(a) that includes a trust exempt from tax under section 501(a);

(2) Annuity plan described in section 403(a);

(3) Annuity contract, custodial account, or retirement income account described in section 403(b)(1), 403(b)(7) or 403(b)(9); and

(4) Qualified bond purchase plan described in section 405(a) prior to that section's repeal by section 491(a) of the Tax Reform Act of 1984 (TRA '84)[1984-3 C.B. (Vol. 1) 1, 356].

(b) *Individual retirement plan.* An individual retirement plan is defined in section 7701(a)(37) and means any individual retirement account described in section 408(a) or individual retirement annuity described in section 408(b). Also, an individual retirement plan includes a retirement bond described in section 409(a) prior to that section's repeal by section 491(b) of the Tax Reform Act of 1984 (TRA '84)[1984-3 C.B. (Vol. 1)1, 356].

(c) *Other distributions.* (1) Distributions under any plan, contract or account that has at any time been treated as a qualified employer plan or individual retirement plan described in paragraph (a) or (b) of this Q&A a-3 will be treated for purposes of section 4981A as distributions from a qualified employer plan or individual retirement plan whether or not such plan, contract, or account satisfies the applicable qualification requirements at the time of the distribution.

(2)(i) For purposes of this paragraph (c), an employer plan will be considered to have been treated as a qualified employer plan if any employer maintaining the plan has at any time filed an income tax return and claimed deductions that would be allowable under section 404 (and that were not disallowed) only if the plan was a qualified employer plan under section 401(a) or 403(a). Similarly, if an income tax return has been filed at any time with respect to the trust (or plan or insurance company), and the income of the trust (insurance company, etc.) is reported (and is not disallowed) based on the trust (or plan) being treated as a qualified employer plan described in section 401(a), or 403(a) or (b), then the employer plan is considered to have been treated as a qualified employer plan.

(ii) For purposes of this paragraph (c), an individual retirement plan (IRA) will be considered to have been treated as a qualified IRA if any contributions to the IRA were either deducted (or designated as a nondeductible contribution described in section 408(o)) on a filed individual income tax return or excluded from an individual's gross income on a filed income tax return because such contributions were reported as regular contributions or rollover contributions (such as those described in section 402(a)(5), 403(a)(4), 403(b)(8), or 408(d)(3)) to an IRA described in section 408(a) or (b) (or section 409 of pre-1984 law). Similar treatment applies to an employer contribution to a simplified employee pension described in section 408(k), if such contribution is deducted on an employer's filed income tax return, including a self-employed individual's return.

a-4: Q. Which distributions with respect to an individual under a qualified employer plan or an individual retirement plan are excluded from consideration for purposes of determining an individual's excess distributions?

A. (a) *Exclusions*. In determining the extent to which an individual has excess distributions for a calendar year, the following distributions are disregarded—

(1) Any distribution received by any person with respect to an individual as a result of the death of that individual.

(2) Any distribution with respect to an individual that is received by an alternate payee under a qualified domestic relations order within the meaning of section 414(p) that is includible in the income of the alternate payee.

(3) Any distribution with respect to an individual that is attributable to the individual's investment in the contract as determined under the rules of section 72(f). This would include, for example, distributions that are excluded from gross income under section 72 because they are treated as a recovery of after-tax employee contributions from a qualified employer plan or nondeductible contributions from an individual retirement plan.

(4) Any portion of a distribution to the extent that it is not included in gross income by reason of a rollover contribution described in section 402(a)(5), 403(a)(4), 403(b)(8), or 408(d)(3).

(5) Any health coverage or any distribution of medical benefits provided under an arrangement described in section 401(h) to the extent that the coverage or distribution is excludible under section 104, 105 or 106.

(b) *Alternate payee*. Any distributions to an alternate payee described in paragraph (a)(2) of this Q&A a-4 must be taken into account by such alternate payee for purposes of calculating the excess distributions received by (or excess accumulations held by) the alternate payee.

a-5: Q. If an annuity contract that represents an irrevocable commitment to provide an employee's benefits under the plan is distributed to an individual, how are the distribution of such annuity contract and distributions of amounts under such a contract taken into account for purposes of calculating excess distributions?

A. Except to the extent that the value of an annuity contract is includible in income in the year the contract is distributed or any subsequent year, the distribution of an annuity contract (including a group annuity contract) in satisfaction of plan liabilities is disregarded for purposes of calculating excess distributions. Any amounts that are actually distributed under the contract to the individual (to the extent not excluded under Q&A a-4 of this section) or are otherwise includible in income with respect to the contract (*e.g.*, by reason of the inclusion in income of the value of the annuity contract in the year of the contract's distribution or any subsequent year) are taken into account for purposes of calculating excess distributions for the calendar year during which such amounts are received or otherwise includible in income. For purposes of this Q&A a-5, the term "plan" means any qualified employer plan or individual retirement plan specified in section 4981A(e) and Q&A a-3 of this section.

a-6: Q. Are minimum distributions required under section 401(a)(9), 408(a)(6), 408(b)(3) or 403(b)(10) taken into account to determine excess distributions?

A. Yes. Distributions received during a calendar year are taken into account in determining an individual's excess distributions for such calendar year even though such distributions are required under section 401(a)(9), 408(a)(6), 408(b)(3) or 403(b)(10). For example, minimum distributions under section 401(a)(9) received during the 1987 calendar year for calendar years 1985 and 1986 will be subject to section 4981A as distributions for 1987.

a-7: Q. Are distributions of excess deferrals permitted under section 402(g)(2), or distributions of excess contributions or excess aggregate contributions permitted under section 401(k) or (m), or distributions of IRA contributions permitted under section 408(d)(4) or (5) taken into account for purposes of calculating excess distributions?

A. No. Distributions of excess deferrals, excess contributions, excess aggregate contributions, distributions of IRA contributions, and income allocable to such contributions or deferrals, that are made in accordance with the provisions of sections 402(g)(2), 401(k)(8), 401(m)(6), or 408(d)(4) or (5) are not taken into account for purposes of calculating excess distributions.

a-8: Q. What distributions from qualified employer plans or individual retirement plans are taken into account in determining an individual's excess distributions?

A. With the exception of distributions noted above in Q&As a-4, a-5, and a-7 of this section, all distributions from qualified employer plans or individual retirement plans must be taken into account in determining an individual's excess distributions for the calendar year in which such distributions are received. In general, all such distributions are taken into account whether or not they are currently includible in income. Thus, for example, net unrealized appreciation in employer securities described in section 402(a) is taken into account in the year distributed. However, health coverage or distributions of medical benefits provided under an arrangement described in section 401(h) that are excludible from income under section 104, 105, or 106 are not subject to section 4981A. In addition, distributions that are excludible from income because they are rolled over to a plan or an individual retirement account are not taken into account. (See Q&A a-4(a)(4) and (5) of this section). Amounts that are includible in income for a calendar year are treated as distributions and, thus, are taken into account even if the amounts are not actually distributed during such year. Thus, deemed distributions to provide insurance coverage includible in income under section 72 (PS-58 amounts), loan amounts treated as deemed distributions under section 72(p), and amounts includible under section 402(b) or section 403(c) by reason of the employer plan or individual retirement plan not being qualified during the year are taken into account.

a-9: Q. Will the dollar threshold amount used to determine an individual's excess distributions be adjusted for inflation in calendar years after 1987?

A. Beginning in 1988, the $112,500 threshold amount is adjusted to reflect post-1986 cost-of-living increases (COLAs) at the same time and in the same manner as the adjustment described in section 415(d). The threshold amount is adjusted even though the distribution is from a defined contribution plan that is subject to a freeze on COLAs because the defined benefit plan limit is below $120,000 (see section 415(c)(1)(A)). However, the $150,000 threshold amount is not adjusted to reflect such increases.

b. *Special Grandfather Rule*

b-1: Q. How are benefits accrued before TRA '86 treated under the excise tax provisions described in section 4981A?

A. (a) *Grandfather amount.* Certain eligible individuals may elect to use a special grandfather rule that exempts from the excise tax the portion of distributions treated as a recovery of such individual's total benefits accrued on or before August 1, 1986 (grandfather amount). However, distributions that are treated as a recovery of the grandfather amount are taken into account in determining the extent to which other distributions are excess distributions (see Q&A b-4 of this section). Under this special grandfather rule, the grandfather amount equals the value of an individual's total benefits (as described in Q&As b-8 and b-9 of this section) in all qualified employer plans and individual retirement plans on August 1, 1986. An individual's benefits in such plans include amounts determinable on August 1, 1986, that are payable to the individual under a qualified domestic relations order within the meaning of section 414(p) (QDRO). However, QDRO benefits that, when distributed, are includible in the income of the alternate payee are not included in the employee's grandfathered amount. Further, plan benefits that are attributable to a deceased individual and that are payable to an eligible individual as a beneficiary are generally not included in determining the eligible individual's grandfather amount. Procedures for determining the grandfather amount are described in Q&As b-11 through b-14 of this section.

(b) *Recovery of grandfather amount.* The portion of any distribution made after August 1, 1986, that is treated as a recovery of a grandfather amount depends on which of two grandfather recovery methods the individual elects. The two alternative methods are described in Q&As b-11 through b-14 of this section. The amount of the distribution for a year that is treated as a recovery of a grandfather amount in a year is applied to reduce the individual's unrecovered grandfather amount for future years (*i.e.*, the individual's accrued benefits as described in Q&As b-8 and b-9 on August 1, 1986, reduced by previous distributions treated as a recovery of a grandfather amount) on a dollar for dollar basis until the individual's unrecovered grandfather amount has been reduced to zero. When the individual's grandfather amount has been reduced to zero, the special grandfather rule ceases to apply and the entire amount of any subsequent excess distributions received is subject to the 15 percent excise tax.

b-2: Q. Who may elect to use the special grandfather rules?

A. Any individual whose accrued benefits as described in Q&As b-8 and b-9 of this section in all qualified plans and individual retirement plans on August 1, 1986 (initial grandfather amount) have a value of at least $562,500 may elect to use the special grandfather rule.

b-3: Q. How does an eligible individual make a valid election to use the special grandfather rule?

A. (a) *Form of election.* An individual who is eligible to use the special grandfather rule must affirmatively elect to use that rule. The election is made on a Form 5329 filed with the individual's income tax return (Form 1040, etc.) for a taxable year beginning after December 31, 1986, and before January 1, 1989 (*i.e.*, the 1987 or 1988 taxable year).

(b) *Information required.* The individual must report the following information on the Form 5329:

(1) The individual's initial grandfather amount.

(2) The grandfather recovery method to be used.

(3) Such other information as is required by the Form 5329.

(c) *Deadline for election.* The deadline for filing such election is the due date, calculated with extensions, for filing the individual's 1988 income tax return. If an individual dies before the expiration of such deadline, an election, or the revocation of a prior election, may be made as part of the final income tax return filed on behalf of such deceased individual by the deceased individual's personal representative. An election or revocation of a prior election may also be filed before the expiration of such deadline with Schedule S (Form 706). See Q&A c-7 of this section.

(d) *Revocation of election.* Elections filed before the deadline may be revoked by filing an amended income tax return for any applicable year. A change in the grandfather recovery method is considered a revocation of a prior election and an amended Form 5329 must be filed for any prior year in which a different grandfather recovery method was used. Thus, a change in the election may require a change in the 1987 tax return. An individual must refile for 1987 based on the new election if additional tax is owed. However, an election (or nonelection) is irrevocable after the filing deadline for the taxable year beginning in 1988 has passed. Thus, an individual who has not made an election by the last day plus extensions for filing the 1988 return may not do so through an amended return.

(e) *Subsequent years.* (1) Any eligible individual who has elected the special grandfather rule must attach to the individual's income tax return for all subsequent taxable years in which the individual receives excess distributions (determined without regard to the grandfather rule) a copy of the Form 5329 on which the individual elected the grandfather rule. A copy of the Form 5329 on which the individual (or the individual's personal representative) elected the grandfather rule must also be filed with Schedule S (Form 706) unless the initial election is filed with such schedule.

(2) The individual must also make such other reports in the form and at the time as the Commissioner may prescribe. See Q&A c-7 of this section for the applicable reporting requirements if the individual or the individual's estate is liable for any tax on excess distributions or on an excess accumulation under section 4981A(a) or (d).

b-4: Q. How do individuals who have elected to use the special grandfather rule determine the extent to which their distributions for any calendar year are excess distributions?

A. (a) *Excess distributions under grandfather rule, threshold amount.* Individuals who elect to use the special grandfather rule are not eligible to use the $150,000 threshold amount in computing their excess distributions for any calendar year. Instead, such electing individuals must compute their excess distributions for a calendar year using a $112,500 (indexed for cost-of-living increases) threshold amount. The rule of this paragraph (a) applies for all calendar years, including the calendar year in which an individual's unrecovered grandfather amount has been reduced to zero and all subsequent calendar years. Once the indexed amount has increased to $150,000 or more, the threshold amount will be the same for all individuals.

(b) *Base for excise tax under grandfather rule.* Although the portion of any distribution that is treated as a recovery of an individual's grandfather amount is not subject to the excise tax, such portion must be taken into account in determining the extent to which the individual has excess distributions for a calendar year. The effect of this rule is that the amount against which the 15 percent excise tax is applied for any calendar year during which a grandfather amount is recovered equals the individual's distributions for such year reduced by the greater of (1) the applicable threshold amount for such year or (2) the grandfather amount recovered for such year. (See the examples in Q&A b-14 of this section.)

b-5: Q. How is the value of an individual's total accrued benefits on August 1, 1986, calculated for purposes of determining (a) whether an individual is eligible to elect the special grandfather rule and (b) the amount of any electing individual's initial grandfather amount under such rule?

A. (a) *Introduction.* The value of an individual's total accrued benefits on August 1, 1986, is the sum of the values of the individual's accrued benefits on such date under all qualified employer plans or individual retirement plans, as determined under this Q&A b-5. If such value exceeds $562,500, the individual may elect the special grandfather rule. In such case, the value so determined may be applied against distributions as determined under this section, whether or not such distributions are from the same plan or IRA for which such grandfather amount is determined. For purposes of determining the value of accrued benefits on August 1, 1986, an annuity contract or an individual's interest in a group annuity contract described in Q&A a-5 of this section is treated as an accrued benefit under the qualified retirement plan or IRA from which it was distributed and an IRA is treated as a defined contribution plan.

(b) *Defined benefit plan*—(1) *General rule.* The amount of an individual's accrued benefit on August 1, 1986, under a defined benefit plan is determined as of that date under the provisions of the plan based on the individual's service and compensation on that date. The present value of such benefit is determined by an actuarial valuation of such accrued benefit performed as of August 1, 1986. Alternatively, accrued benefits may be determined as of July 31, 1986. In such case, the applicable rules are applied by substituting the July 31 date for the August date in the applicable provisions. (See Q&A b-9 of this section for rules for determining the amount of benefits and values and the actuarial assumptions to be used in such determination.)

(2) *Alternative method.* Alternatively, the present value of an individual's accrued benefit on August 1, 1986, may be determined using the following method:

(i) Determine the amount of the individual's actual accrued benefit (prior benefit) on the valuation date that immediately precedes August 1, 1986 (prior date). The valuation date for purposes of using this alternative method is the valuation date used for purposes of section 412. In making this determination, plan amendments that are adopted after that prior date are disregarded.

(ii) Determine the amount of the individual's adjusted accrued benefit (adjusted prior benefit) on the prior date by reducing the prior benefit in paragraph (b)(2)(i) of this Q&A b-5 by the amount of distributions that reduce the accrued benefit or transfers from the plan and by increasing the prior benefit in paragraph (b)(2)(i) of this Q&A b-5 by any increase in benefit resulting from either transfers to the plan or plan amendments that were made (or, in the case of a plan amendment, both adopted and effective) after the prior valuation date, but on or before August 1, 1986.

(iii) Determine the amount of the individual's actual accrued benefit (future benefit) on the valuation date immediately following August 1, 1986 (next date). In making this determination, plan amendments, etc. that are either adopted or effective after August 1 are disregarded.

(iv) Determine the amount of the individual's adjusted accrued benefit (adjusted future benefit) on the next date by increasing the future benefit in paragraph (b)(2)(iii) of this Q&A b-5 by the amount of any distributions that reduce the accrued benefit or transfers from the plan and by reducing the future benefit in paragraph (b)(2)(iii) of this Q&A b-5 by the amount of any transfer to the plan that was made after August 1, 1986, but on or before the next valuation date to the amount in paragraph (b)(2)(iii) of this Q&A b-5.

(v) Calculate the weighted average of paragraphs (b)(2)(ii) and (b)(2)(iv) of this Q&A b-5, where the weights applied are the number of complete calendar months separating the applicable prior date and the applicable next date, respectively, and August 1, 1986.

(vi) Determine the actuarial present value of the benefit in paragraph (b)(2)(v) of this Q&A b-5 as of August 1, 1986, using the methods and assumptions described in Q&A b-9 of this section. The grandfather amount on August 1, 1986, attributable to the accrued benefits under the defined benefit plan is equal to the amount determined in paragraph (b)(2)(vi) of this Q&A b-5.

(3) *Certain insurance plans treated as defined contribution plans.* (i) Accrued benefits not in pay status un-

der a plan satisfying the requirements of section 411(b)(1)(F) are determined under the rules in paragraph (c) of this Q&A b-5 for defined contribution plans. For purposes of applying paragraph (c) of this Q&A b-5 to such benefits, the cash surrender value of the contract is substituted for the account balance. If accrued benefits are in pay status under such a plan, the rules of this paragraph (b) apply to such benefits.

(ii) Accrued benefits not in pay status that are attributable to voluntary employee contributions (including rollover amounts) to a defined benefit plan are determined under the rules in paragraph (c) of this Q&A b-5 as if the account balance attributable thereto is under a defined contribution plan. If such benefits are in pay status and are used to fund the benefit under the defined benefit plan, the rules of this paragraph (b) apply to such benefits.

(c) *Defined contribution plan*—(1) *General rule*. The value of an individual's accrued benefit on August 1, 1986, under a defined contribution plan (including IRAs) is the value of the individual's account balance on such date (or on the immediately preceding day). Paragraph (b)(3) of this Q&A b-5 requires that benefits derived from certain insured plans and from voluntary contributions to a defined benefit plan be determined under the rules of this paragraph (c).

(2) *Alternative method*. Alternatively, if a valuation was not performed as of August 1, 1986 (or as of the immediately preceding day), the value of an individual's accrued benefit may be determined as follows:

(i) Determine the value of the individual's account balance on the valuation date immediately preceding August 1, 1986 (prior valuation date).

(ii) Determine the value of the individual's adjusted account balance on the prior valuation date by subtracting (or adding, respectively) the amount of any distribution, including a transfer to another plan or a forfeiture from the account balance (or the amount of any allocation to the account balance, including a transfer from another plan, rollover received or forfeiture from another account) that was made after the prior valuation date but on or before August 1, 1986, from (or to) the amount in paragraph (c)(2)(i) of this Q&A b-5.

(iii) Determine the value of the individual's account balance on the valuation date immediately following August 1, 1986 (next valuation date).

(iv) Determine the value of the individual's adjusted account balance on the next valuation date by adding (or subtracting, respectively) the amount of any distribution, of a type described in paragraph (c)(2)(ii) of this Q&A b-5 (or the amount of any allocation to the account balance, of a type described in paragraph (c)(2)(ii) of this Q&A b-5), that was made after August 1, 1986, but on or before the next valuation date to (or from) the amount in paragraph (c)(2)(iii) of this Q&A b-5.

(v) Calculate the weighted average of paragraphs (c)(2)(ii) and (c)(2)(iv) of this Q&A b-5, where the weights applied are the number of complete calendar months separating the applicable valuation date and the applicable next date, respectively, and August 1, 1986.

The grandfather amount on August 1, 1986, attributable to the account balance in the defined contribution plan or the individual retirement plan is the amount in paragraph (c)(2)(v) of this Q&A b-5.

b-6: Q. For purposes of determining the value of accrued benefits in a defined contribution plan or a defined benefit plan on August 1, 1986, are nonvested benefits taken into account?

A. Yes. All accrued benefits, whether or not vested, are taken into account.

b-7: Q. To what extent are benefits payable with respect to an individual under a qualified employer plans or an individual retirement plan not taken into account for purposes of calculating the individual's grandfather amount?

A. (a) *Exclusions*. The following benefits payable with respect to an individual are not taken into account for purposes of this calculation:

(1) Benefits attributable to investment in the contract as defined in section 72(f). However, amounts attributable to deductible employee contributions (as defined in section 72(o)(5)(A)) are considered part of the accrued benefit.

(2) Amounts that are determinable on August 1, 1986, as payable to an alternate payee who is required to include such amounts in gross income (a spouse or former spouse) under a qualified domestic relations order (QDRO) within the meaning of section 414(p).

(3) Amounts that are attributable to IRA contributions that are distributed pursuant to section 408(d)(4) or (5).

(b) *Alternate payee*. Under a QDRO described in paragraph (a)(2) of this Q&A b-7, amounts are considered part of the accrued benefit of the alternate payee for purposes of calculating the value of the alternate payee's accrued benefit on August 1, 1986. Similarly, such amounts are used by the alternate payee to compute excess distributions.

b-8: Q. What adjustments to the grandfather amount are necessary to take into account rollovers from one qualified employer plan or individual retirement plan to another such plan?

A. (a) *Rollovers outstanding on valuation date*. Generally, rollovers between plans result in adjustments to the grandfather amount under the rules in Q&A b-5 of this section. However, if a rollover amount is distributed from one plan on or before an applicable valuation date of such plan and is rolled over into the receiving plan after the receiving plan's applicable valuation date and if these events result in an inappropriate duplication or omission of the rollover amount, then an adjustment to the grandfather amount must be made to remove the duplication or omission. The Commissioner may provide necessary rules concerning this adjustment.

(b) *Valuation*. If the rollover amount described in paragraph (a) of this Q&A b-8 is in a form of property other than cash, the property of which the outstanding rollover consists is valued as of the date the rollover contribution is received by the transferee qualified employer plan or individual retirement plan and that value is the amount of the rollover. If the outstanding rollover is in the form of cash, the amount of the cash is the amount of the rollover.

b-9: Q. What is the form of the grandfather benefit under a defined benefit plan and how is it valued?

A. (a) *Benefit form.* The grandfather amount under a defined benefit plan is determined on the basis of the form of benefit (including any subsidized form of benefit such as a subsidized early retirement benefit or a subsidized joint and survivor annuity) provided under the plan as of August 1, 1986 that has the greatest present value as determined in paragraph (b) of this b-9. If the plan provides a subsidized joint and survivor annuity, for purposes of determining the grandfather amount, it will be assumed that an unmarried individual is married and that the individual's spouse is the same age as the individual. Assumptions as to future withdrawals, future salary increases or future cost-of-living increases are not permitted.

(b) *Value of grandfather amount.* The grandfather amount under a defined benefit plan is the present value of the individual's benefit form determined under paragraph (a) of this Q&A b-9. Thus, the benefit form is reduced to reflect its value on the applicable valuation date. The present value of the benefit form on August 1, 1986, or the applicable date, is computed using the factors specified under the terms of the plan as in effect on August 1, 1986, to calculate a single sum distribution if the plan provides for such a distribution. If the plan does not provide for such a distribution form, such present value is computed using the interest rate and mortality assumptions specified in §20.2031-7 of the Estate Tax Regulations.

b-10: Q. Is the plan administrator (or trustee) of a qualified plan (or individual retirement account) required to report to an individual the value of the individual's benefit under the plan as of August 1, 1986?

A. (a) *Request required.* No report is required unless the individual requests a report and the request is received before April 15, 1989. If requested, the plan administrator (or trustee or issuer) must report to such individual the value of the individual's benefit under the plan as of August 1, 1986, determined in accordance with Q&A b-5 through b-9 of this section. Such report must be made within a reasonable time after the individual's request but not later than July 15, 1989.

(b) *Other rules.* Alternate payees must make their own request for valuation reports. Any report furnished to an employee who has an alternate payee with respect to the plan must include the separate values attributable to each such individual. Any report furnished to an alternate payee must include only the value attributable to the alternate payee. Reports may be furnished to individuals even if no request is made. Individuals must keep records of the reports received from plans or IRAs in order to substantiate all grandfather amounts.

(c) *Authority.* The rules in this Q&A are provided under the authority in section 6047(d).

b-11: Q. How is the portion of a distribution that is treated as a recovery of an individual's grandfather amount as described in b-1 of this section to be calculated?

A. (a) *General rule.* All distributions received between August 1 and December 31, 1986, inclusive, are treated as a recovery of a grandfather amount. The portion of distributions received after December 31, 1986, that is treated as a recovery of the grandfather amount is determined under either the discretionary method or the attained age method. An amount that is treated as a recovery of grandfather benefits is applied to reduce the initial grandfather amount that was calculated as of August 1, 1986, on a dollar for dollar basis until the unrecovered amount has been reduced to zero. No other recalculation of the grandfather amount is to be made for a date after August 1, 1986.

(b) *Methods, etc.* The grandfather amount may be recovered by an individual under either the discretionary method or the attained age method. After the individual's total grandfather amount is treated as recovered under either method, the tax on excess distributions and excess accumulations is determined without regard to any grandfather amount.

b-12: Q. Under the discretionary method, what portion of each distribution is treated as a return of the individual's grandfather amount?

A. (a) *Initial percentage.* Under the discretionary method, unless the individual elects in accordance with paragraph (b) below, 10 percent of the total distributions that the individual receives during any calendar year is treated as a recovery of the grandfather amount.

(b) *Acceleration.* The individual may elect to accelerate the rate of recovery to 100 percent of the total aggregate distributions received during a calendar year commencing with any calendar year, including 1987 (acceleration election). In such case, the rate of recovery is accelerated to 100 percent for the calendar year with respect to which the election is made and for all subsequent calendar years.

(c) *Election.* To recover the grandfather amount using the discretionary method, an individual must elect to use such method when making the election to use the special grandfather rule on the Form 5329. (See Q&A b-3 of this section.) The acceleration election must be made for the individual's taxable year beginning with or within the first calendar year for which such election is made and must be filed with the individual's income tax return for that year. Such acceleration election may also be made or revoked retroactively on an amended return for such year. However, the acceleration election may not be made after the individual's death other than with the individual's final income tax return or with a return for a prior year for which a return was not filed before the individual's death. Thus, the acceleration election may not be made on an amended return filed after the individual's death for a year for which a return was filed before the individual's death. The preceding two sentences shall not apply to deaths occurring in 1987 or 1988. The estate is entitled to use the remaining grandfather amount to determine if there is an excess accumulation. See Q&A d-3 of this section. The acceleration election shall be made on such form and in such manner as the Commissioner prescribes in a manner consistent with the rules of this section.

best copy available

b-13: Q. Under the attained age method, what portion of each distribution is treated as a return of the individual's grandfather amount?

A. Under the attained age method, the portion of total distributions received during any year that is treated as a recovery of an individual's grandfather amount is calculated by multiplying the individual's aggregate distributions for a calendar year by a fraction. The numerator of the fraction is the difference between the individual's attained age in completed months on August 1, 1986, and the individual's attained age in months at age 35 (420 months). The denominator of the fraction is the difference between the individual's attained age in completed months on December 31 of the calendar year and the individual's attained age in months at age 35 (420 months). An individual whose 35th birthday is after August 1, 1986, may not use the attained age method.

b-14. Q. How is the 15 percent tax with respect to excess distributions for a calendar year calculated by an individual who has elected to use the special grandfather rule?

A. The calculation of the excise tax may be illustrated by the following examples:

Example 1. (a) An individual (A) who participates in two retirement plans, a qualified defined contribution plan and a qualified defined benefit plan, has a total value of accrued benefits on August 1, 1986 under both plans of $1,000,000. Because this amount exceeds $562,500, A is eligible to elect to use the special grandfather rule to calculate the portion of subsequent distributions that are exempt from tax. A elects to use the discretionary grandfather recovery method and attaches a valid election to the 1987 income tax return. A does not elect to accelerate the rate of recovery for 1987. On October 1, 1986, A receives a distribution of $200,000. On February 1, 1987, A receives a distribution of $45,000 and, on November 1, 1987, receives a distribution of $200,000. The 15 percent excise tax applicable to aggregate distributions in 1987 is calculated as follows:

(1)	Value of grandfather amount on 8/1/86	$1,000,000
(2)	Grandfather amounts recovered in 1986 but after 8/1/86	$200,000
(3)	Value of grandfather amount on 12/31/86 ((1) − (2))	$800,000
(4)	Grandfather recovery percentage	10%
(5)	Distributions between 1/1/87 and 12/31/87 ($45,000 + $200,000)	$245,000
(6)	Portion of (5) exempt from tax ((4) × (5))	$24,500
(7)	Amount potentially subject to tax ((5) − (6))	$220,500
(8)	Portion of aggregate distributions in excess of $112,500 ($45,000 + $200,000 − $112,500)	$132,500
(9)	Amount subject to tax (lesser of (7) and (8))	$132,500
(10)	Amount of tax (15% of (9))	$19,875
(11)	Remaining undistributed value of grandfather amount as of 12/31/87 ((3) − (6))	$775,500

(b) In 1988, A receives no distributions from either plan. On February 1, 1989, A receives a distribution of $300,000 and on December 31, 1989, receives a distribution of $75,000. A makes a valid acceleration election for the 1989 taxable year, whereby A accelerates the rate of grandfather recovery that will apply for calendar years after 1988 to 100 percent. Assume the annual threshold amount for the 1989 calendar year is $125,000 (i.e., 112,500 indexed). The 15 percent excess tax applicable to distributions in 1989 is calculated as follows:

(1)	Value of grandfather amount on 1/1/89	$775,500
(2)	Grandfather recovery percentage designated for 1989 calendar year	100%
(3)	Distributions between 1/1/89 and 12/31/89 ($300,000 + $75,000)	$375,000
(4)	Portion of (3) exempt from tax (2) × (3)	$375,000
(5)	Amount potentially subject to tax ((3) − (4))	$ 0
(6)	Portion of aggregate distributions in excess of $125,000 ($300,000 + $75,000 − $125,000)	$250,000
(7)	Amount subject to tax (lesser of (5) and (6))	$ 0
(8)	Amount of tax (15% of (7))	$ 0
(9)	Remaining undistributed value of grandfather amount as of 12/31/89 ((1) − (4))	$400,500

The entire amount of any distribution for subsequent calendar years will be treated as a recovery of the grandfather amount and applied against the grandfather amount until the unrecovered grandfather amount is reduced to zero.

Example 2. The facts are the same as in *Example 1* except that A elects to use the attained age recovery method and A makes a valid election for the 1987 taxable year. Further assume that A's attained age in months on August 1, 1986 is 471 months and on December 31, 1987 is 488 months. The 15 percent excise tax applicable to aggregate distributions in 1987 is calculated as follows:

(1)	Value of grandfather amount on 8/1/86	$1,000,000
(2)	Grandfather amounts recovered in 1986 but after 8/1/86	$200,000
(3)	Value of grandfather amount on 12/31/86 ((1) − (2))	$800,000
(4)	Completed months of age in excess of 420 on 8/1/86	51
(5)	Completed months of age in excess of 420 on 12/31/87	68
(6)	Grandfather fraction as of 12/31/86 ((4) divided by (5))	3/4
(7)	Distributions between 1/1/87 and 12/31/87 ($45,000 + $200,000)	$245,000
(8)	Portion of (7) exempt from tax ((6) × (7))	$183,750
(9)	Amount potentially subject to tax ((7) − (8))	$61,250
(10)	Portion of aggregate distributions in excess of $112,500 ($45,000 + $200,000 − $112,500)	$132,500
(11)	Amount subject to tax (lesser of (9) and (10))	$61,250
(12)	Amount of tax (15% of (11))	$9,187
(13)	Unrecovered grandfather amount as of 12/31/87 ((3) − (8))	$616,250

c. *Special Rules*

c-1: Q. How is the excise tax computed if a person elects special tax treatment under section 402 or 403 for a lump sum distribution?

A. (a) *General rule*—(1) *Conditions.* Section 4981A(c)(4) provides for a special tax computation that applies to an individual in a calendar year if the individual receives distributions that include a lump sum distribution and the individual makes certain elections under section 402 or 403 with respect to that lump sum distribution (lump sum election).

(2) *Lump sum election.* A lump sum election includes an election of (i) 5-year income averaging under section 402(e)(4)(B); (ii) phaseout capital gains treatment under sections 402(a)(2) or 403(a)(2) prior to their repeal by section 1122(b) of TRA '86 and as permitted under section 1122(h)(4) of TRA '86; (iii) grandfathered long-term capital gains under sections 402(a)(2) and 403(a) prior to such repeal and as permitted by section 1122(h)(3) of TRA '86; and (iv) grandfathered 10-year income averaging under section 402(e) (including such treatment under a section 402(e)(4)(L) election) prior to amendment by section 1122(a) of TRA '86 and as permitted by section 1122(h)(3)(A)(ii) and (5) of the TRA '86 [1986-3 C.B. (Vol. 1) 1, 383].

(3) *Special tax computation.* (i) If the conditions in paragraph (a)(1) of this Q&A c-1 are satisfied for a calendar year, the rules of this subparagraph (a)(3) apply for purposes of determining whether there are excess distributions and tax under section 4981A.

(ii) All distributions are divided into two categories. These two categories are the lump sum distribution and other distributions. Whether or not particular distribution is a distribution subject to section 4981A and is in either category is determined under the rules in section 4981A and this section. Thus, the exclusions under section 4981A(c)(2) and Q&A a–4(a) of this section apply here. For example, a distribution that is a tax-free recovery of employee contributions is not in either category.

(iii) The excise tax under section 4981A(c)(1) is computed in the normal manner except that (A) it is the sum of the otherwise applicable taxes determined separately for the two categories of excess distributions and (B) a different amount (threshold amount) is subtracted from the distributions in each category in determining the amount of the excess distributions. The threshold amount that is subtracted from the portion of the distributions that is not part of the lump sum distribution is the applicable threshold amount, determined without regard to section 4981A(c)(4) and the lump sum election. Thus, the threshold amount subtracted from the amount in this category is either the $150,000 amount or the $112,500 amount (indexed). The threshold amount that is subtracted from the amount of the lump sum distribution is 5 times the applicable threshold amount as described above. Thus, the threshold amount subtracted from the lump sum distribution is $750,000 or 5 times $112,500 indexed (initially $562,500).

(b) *Grandfather rule.*—(1) *In general.* This paragraph (b) provides special rules where an individual makes both the grandfather election described in section 4981A(c)(5) and the lump sum election described in paragraph (a) of this Q&A c–1. See Q&A b–11 through 14 for other rules that apply to such grandfather election.

(2) *Discretionary method.* If the individual uses the discretionary method, described in Q&As b–11 and 12 of this section, the applicable threshold amount is $112,500 (indexed). Under this method, the grandfather amount is recovered at a 10 percent or 100 percent rate in any calendar year and is offset separately against distributions in each category of distributions at the appropriate rate. If, for any calendar year, distributions are received in both categories and the total of the appropriate percentage (10 percent or 100 percent) of the distributions in each category exceed the unrecovered grandfathered account, then such grandfather amount must be recovered ratably from the distributions in each category. This rule applies even if the distributions in one category are less than the threshold amount for that category and the distributions in the other category exceed the threshold amount for that category.

(3) *Attained age method.* If the individual uses the attained age method, described in Q&As b–11 and 13 of this section, the threshold amount is $112,500 (indexed). Under this method, to determine the portion of the distributions in each category that is treated as a recovery of the grandfather amount, the fraction described in Q&A b–13 of this section is applied separately to the distributions in each category of distributions. If, for any calendar year, distributions are received in both categories and the total of the amounts of the distributions in each category that are treated as a recovery of the grandfather amount exceeds the unrecovered grandfather amount, then such grandfather amount must be recovered ratably from the distributions in each category. This rule applies even if the distributions in one category are less than the threshold amount for that category and the distributions in the other category exceed the threshold amount for that category.

(c) *Amount in lump sum category.* All amounts received from the employer that are required to be distributed to the individual in order to make a lump sum election described in paragraph (a) of this Q&A c–1 are included in the lump sum category. Amounts are in the lump sum category even though they are not subject to income tax under the election. Thus, for example, the following amounts would be in the lump sum category: (1) appreciation on employer securities received as part of a distribution for which a lump sum treatment is elected; and (2) amounts that are phased out when section 1122 of TRA '86 is elected. However, accumulated deductible employee contributions under the plan (within the meaning of section 72(o)(5)) are in the nonlump sum category.

(d) *Examples.* The rules in this Q&A C–1 are illustrated by the following examples:

Example (1). (a) On January 1, 199X, individual A who is age 65 and is a calendar year taxpayer receives a lump sum distribution described in section 402(e)(4)(A) from a qualified employer plan (Plan X). A receives no other distribution in 199X. A elects 5-year income averaging under section 402(e)(4)(B) and also elects section 402(e)(4)(L) treatment (treating pre-74 participation as post-1973 participation) on A's income tax return for 199X. Thus, A also makes the lump sum election described in paragraph (a)(2), above. For 199X, the $112,500 threshold amount indexed is $125,000. A does not make a grandfather election so that A's threshold amount is $150,000.

(b) A's distribution from Plan X consists of cash in the amount of $800,000. A has a section 72(f) investment in the contract. A has over the years made after tax contributions to Plan X of $50,000. A's distributions subject to section 4981A equal $750,000 because of the exclusion of A's $50,000 after-tax contributions.

(c) A's distributions consist solely of amounts in the lump sum category. A's threshold amount equals $750,000 under the rules of this paragraph (a)(iii), above, (5 times $150,000). Because A's threshold amount ($750,000) equals the amount of A's distribution from Plan X ($750,000) no part of A's distribution from Plan X is treated as an excess distribution subject to the 15-percent excise tax.

Example (2). (a) Assume the same facts as in *Example (1)*, except that A receives an additional distribution from an individual retirement plan described in section 408(a)(IRA Y) in 199X of $150,000. A has made no nondeductible contributions to IRA Y and all of the $150,000 is a distribution subject to section 4981A.

(b) A's distributions consist of two categories, the lump sum category (Plan X $750,000) and the other than lump sum category (IRA Y $150,000). A separate threshold amount is subtracted from A's IRA Y distribution. This threshold amount equals $150,000 under the rules of this paragraph (a)(3), above, the same initial threshold amount that is applied against the lump sum prior to the multiplication by 5). Because A's threshold amount ($150,000) equals the amount of A's distribution from IRA Y ($150,000), no part of A's distribution from IRA Y would be treated as an excess distribution subject to the 15-percent excise tax.

Example (3). (a) Assume the same facts as in *Example (2)*, except that A's distribution is $825,000 from Plan X, before reduction of $50,000 for employee contributions, instead of $800,000, so that A's distribution subject to section 4981A from Plan X is $775,000. A made a valid grandfather election. Therefore, the applicable threshold amount is $125,000 ($112,500 indexed for 199X). A's unrecovered grandfather amount as of the end of the year preceding 199X is $1,000,000 (A had a benefit under another retirement plan (Plan Z), on August 1, 1986, and A's account balance under Plan Z, which is a stock bonus plan, is $6,000,000 on January 1, 199X). A also made a valid election of the discretionary method to recover A's grandfather amount.

(b) If A recovers A's grandfather amount in 199X at the 10 percent rate, 10 percent of A's distributions that are in the lump sum category (Plan X $775,000) is treated as a recovery of A's grandfather amount. Similarly, 10 percent of A's distributions that are in the other than lump sum category (IRA Y $150,000) is treated as a recovery of A's grandfather amount. Thus, A's grandfather amount is reduced by $92,500 ($77,500 Plan X and $15,000 IRA Y) for the 199X calendar year and is $907,500 on January 1 of the year following 199X. Because the amounts of the distributions in each category that are treated as a recovery of grandfather amount are less than the applicable threshold amount for each category ($625,000 Plan X, $125,000 IRA Y), the recovery of the grandfather amount does not affect the calculations of the 199X excise tax.

(c) Because A's distribution from IRA Y of $150,000 exceeds A's threshold amount of $125,000 ($112,500 indexed) applicable to nonlump sum distributions by $25,000 and A's distribution subject to section 4981A from Plan X of $775,000 exceeds A's threshold amount of $625,000 (5 × $125,000) applicable to lump sums by $150,000, A is subject to the 15-percent excise tax. A's tax under section 4981A is $26,250 (15 percent of $25,000 plus 15 percent of $150,000).

Example (4). (a) Assume the same facts as in *Example (3)* except that A makes a valid acceleration election under the discretionary method with respect to A's grandfather amount of $1,000,000 for calendar year 199X.

(b) Because A's grandfather amount on January 1, 199X ($1,000,000) equals or exceeds A's distribution subject to section 4981A ($925,000) for 199X, no part of A's distribution from Plan X or IRA Y would be treated as excess distribution subject to the 15-percent excise tax.

(c) A's distributions subject to 4981A from Plan X of $775,000 and from IRA Y of $150,000 are offset 100 percent by A's grandfather amount of $1,000,000. Therefore, A's grandfather amount on January 1 of the year following 199X is $75,000 ($1,000,000 minus $925,000). This $75,000 would be required to be offset 100 percent against any distributions received in that year.

Example (5). (a) Assume the same facts as in *Example (4)*, except that A's distribution subject to section 4981A from Plan X, after reduction of the $50,000 for employee contributions, is $1,000,000 and from IRA Y is $125,000 (equal to the threshold amount), totaling $1,125,000.

(b) Because the sum of the amount received in the lump sum category and the other than lump sum category of distributions is greater than the grandfather amount ($1,000,000), the grandfather amount must be allocated to each separate category on the basis of the ratio of the amount received in each category to the sum of these amounts. Thus, $888,889 ($1,000,000 × ($1,000,000 divided by $1,125,000)) is allocated to the lump-sum category and $111,111 ($1,000,000 X ($125,000 divided by $1,125,000)) is allocated to the other than lump sum category. A's distributions of $1,000,000 in the lump sum category are reduced by $888,889, the greater of $625,000 (the threshold amount) or $888,889 (grandfather amount), and equal $111,111. A's excise tax is $16,666 (15 percent of $111,111). A owes no excess distribution tax on the $125,000 received from IRA Y because it is fully offset by the threshold amount of $125,000.

(c) Because A's distribution subject to section 4981A for the year of $1,125,000 ($1,000,000 plus $125,000) exceeds A's grandfather amount on January 1, 199X of $1,000,000, A's grandfather amount is zero for all subsequent calendar years.

c–2: Q. Must retirement plans be amended to limit future benefit accruals so that the amounts that are distributed would not be subject to an excise tax under section 4981A?

A. No. A qualified employer plan need not be amended to reduce future benefits so that the amount of annual aggregate distributions are not subject to tax under section 4981A. Section 415 does, however, require plan provisions that limit the accrual of benefits and contributions to specified amounts. The operation of the excise tax of section 4981A is independent of plan qualification requirements limiting benefits and contributions under qualified plans.

c–3: Q. Is a plan amendment reducing accrued benefits a permitted method of avoiding the excise tax?

A. No. Accrued benefits may not be reduced to avoid the imposition of the excise tax. Such reduction would violate employer plan qualification requirements, including section 411(d)(6).

c–4: Q. To what extent is the 15 percent section 4981A tax reduced by the 10 percent section 72(t) tax?

A. (a) *General rule.* The 15 percent tax on excess distributions may be offset by the 10 percent tax on early distributions to the extent that the 10 percent tax is applied to excess distributions. For example, assume that individual (A), age 56, receives a distribution of $200,000 from a qualified employer plan (Plan X) during calendar year 1987. Further, assume that the entire distribution is subject to the 10-percent tax of section 72(t). A tax of $20,000 (10% of $200,000) is imposed on the distribution under section 72(t). Assuming that the distribution is not a lump sum distribution eligible for special tax treatment under section 402, part of the distribution is subject to tax under section 4981A. If A does not elect the special grandfather rule, A's dollar limitation is $150,000 and the amount of the $200,000 distribution that is an excess distribution is $50,000 ($200,000 – $150,000). The 15 percent tax is $7,500 (15% of $50,000). The portion of the $20,000 section 72(t) tax on early distributions that is attributable to the excess distribution is $5,000 (10% of $50,000). This amount is credited against the section 4981A tax. Therefore, the total tax imposed on the distribution under both provisions is $22,500 ($20,000 + ($7,500 – $5,000)).

(b) *Example.* (1) If some, but not all, distributions made for a calendar year are subject to the section 72(t) tax, the offset is applied only to the extent that the section 72(t) tax applies to amounts that exceed the applicable threshold amount for that calendar year. For example, assume that during 1987 individual B receives a distribution of $40,000 that is not subject to the 10 percent section 72(t) tax and a separate distribution of $160,000 that is subject to the 10 percent section 72(t) tax. A tax of $16,000 (10% of $160,000) is imposed by section 72(t). Excess distributions for the year, assuming B does not elect the special grandfather rule, are $50,000 ($40,000 + $160,000 – $150,000). The tax under section 4981A is $7,500 (15% of $50,000). For purposes of determining the extent to which the 10 percent tax is applied to excess distributions, the only amounts subject to the 10 percent tax that are taken into account are distributions in excess of $150,000 (or if greater, the $112,500 (indexed) threshold for the year). The amount of distributions for 1987 to which the 10 percent tax is applicable $160,000) exceeds $150,000 by $10,000. Thus, the portion of the section 72(t) tax of $16,000 that is attributable to excess distributions equals $1,000 (10 percent of $10,000). This amount is credited against the section 4981A tax. The total tax payable under the provisions of sections 72(t) and 4981A is $22,500 ($16,000 + ($7,500 – $1,000)).

(c) *Net unrealized appreciation.* A distribution consisting of net unrealized appreciation of employer securities that is excluded from gross income is not subject to section 72(t) and, therefore, there is no section 72(t) tax on such distribution that may be used to offset the tax on excess distributions.

c–5: Q. If a distribution that is subject to both the 10 percent tax on early distributions from qualified plans imposed under section 72(t) and the 15 percent tax on excess distributions imposed under section 4981A is received by an individual who elects to calculate the 15 percent tax using the special grandfather rule, how is the offset of the 10 percent tax imposed under section 72(t) calculated?

A. The section 4981A tax is reduced only by the amount of the 10 percent tax that is attributable to the portion of the distribution to which the section 4981A tax applies. For example, assume that (a) an individual (A), age 57, receives during 199X a distribution from a qualified plan of $325,000 that is subject to the 10 percent section 72(t) tax; (b) the distribution is not a lump sum distribution and is subject to the 15 percent excise tax imposed by section 4981A; (c) A has elected to use the special grandfather rule; and (d) A accelerates the rate of recovery of the remaining grandfather amount of $250,000 so that only $75,000 of this distribution is subject to the section 4981A tax. Thus, the section 4981A tax is $11,250 (15% of $75,000). The portion of the section 72(t) 10 percent tax that is offset against the section 4981A tax of $11,250 is limited to $7,500 (10% of $75,000), the section 72(t) tax on the amount of distributions after taking into account the reduction under the grandfather rule.

c-6: Q. When do distributions become subject to the excise tax under section 4981A?

A. (a) *General rule.* Excess distributions made after December 31, 1986, are subject to the excise tax under section 4981A.

(b) *Transitional rule*—(1) *Termination.* Distributions prior to January 1, 1988, made on account of certain terminations of a qualified employer plan are not subject to tax under section 4981A. For a plan termination to be eligible for this transitional rule, the plan termination must occur before January 1, 1987. For purposes of applying the rules of section 4981A (except the reporting requirements), any such distribution is treated as if made on December 31, 1986. The distribution of an annuity contract is not an excepted distribution. See Q&A a-5 of this section.

(2) *Lump sum distributions.* A lump sum distribution that an individual who separates from service in 1986 receives in calendar year 1987 before March 16 is treated as a distribution received in 1986 if such individual elects to treat it as received in 1986 under the provisions of section 1124 of TRA '86. Thus, such a qualifying section 1124 distribution is not subject to tax under section 4981A for 1987. For purposes of applying the rules of section 4981A, the amount attributable to such distribution is included in the individual's August 1, 1986 accrued benefit and such distribution is treated as if made on December 31, 1986.

(3) *Grandfather amount recovery.* If an individual described in this paragraph elects the special grandfather rule, the entire amount of distributions described in subparagraph (1) or (2) of this paragraph (b) is treated as a recovery of the individual's grandfather amount because it is treated as received on December 31, 1986. Thus, the individual's outstanding grandfather amount as of the date of the distribution is reduced by the amount of such distribution.

c-7: Q. How is the tax on excess distributions or on excess accumulations under section 4981A reported?

A. (a) *Tax on excess distributions.* An individual liable for tax on account on excess distributions under section 4981A must complete Form 5329 and attach it to his income tax return for the taxable year beginning with or within the calendar year during which the excess distributions are received. The amount of the tax is reported on such form and in such manner as prescribed by the Commissioner.

(b) *Tax on excess accumulations*—(1) *General rule.* If, with respect to the estate of any individual, there is a tax under section 4981A(d) on account of the individual's excess accumulations, the amount of such tax is reported on Schedule S (Form 706 or 706NR). Schedule S must be filed on or before the due date under section 6075 including extensions, for filing the estate tax return. The tax under section 4981A(d) must be paid by the otherwise applicable due date for paying the estate tax imposed by chapter 11 even if, pursuant to section 6018(a), no return is otherwise required with respect to the estate tax imposed by chapter 11.

(2) *Earliest due date.* Notwithstanding paragraph (b)(1) of this c-7, the due date for filing Schedule S (Form 706) and paying the tax on excess accumulations under section 4981A(d) is not earlier than February 1, 1988. Thus, with respect to the estates of individuals dying in January through April of 1987, the due date for filing Schedule S (Form 706) and paying any tax owed under section 4981A(d) is not earlier than February 1, 1988 even if the due date for filing the Schedule 706 and paying the estate tax imposed by chapter 11 is an earlier date. Further, no interest or penalties will be charged for failure to pay any tax on excess accumulations under section 4981A before January 31, 1988.

c-8: Q. Does the fact that the benefits under a qualified retirement plan or individual retirement account are community property affect the determination of the excise tax under section 4981A?

A. Generally, no. The operation of community property law is disregarded in determining the amount of aggregate annual distributions. Thus, the excise tax under section 4981A is computed without regard to the spouse's community property interest in the individual's or decedent's distributions or accumulation. Also, any reporting to the individual by a trustee, must be done on an aggregate basis without regard to the community property law.

d. *Excess Accumulations*

d-1: Q. To what extent does section 4981A increase the estate tax imposed by chapter 11 with respect to the estates of any decedents?

A. Section 4981A(d) provides that the estate tax imposed by chapter 11 with respect to the estate of any decedent is increased by an amount equal to 15 percent of the decedent's excess accumulation. See Q&A d-2 through d-7 of this section for rules for determining the decedent's excess accumulation. See Q&A d-8 of this section concerning credits under section 2010 through 2016. See Q&A d-9 of this section for examples illustrating the determination of the increase in estate tax under section 4981A(d).

d-2: Q. How is the amount of an decedent's excess accumulation determined?

A. (a) *General rule.* A decedent's excess accumulation is the excess of (1) the aggregate value of the decedent's interests in all qualified employer plans and individual retirement plans (decedent's aggregate interest) as of the date of the decedent's death over (2) an amount equal to the present value of a hypothetical life annuity determined under Q&A d-7 of this section. If the personal representative for the individual's estate elects to value the property in the gross estate under section 2032, the applicable valuation date prescribed by section 2032 shall be substituted for the decedent's date of death.

(b) *Other rules.* See Q&A d-3 and d-4 of this section if the decedent or, where appropriate, the decedent's personal representative validly elects the special grandfather rule and has any unused grandfather benefit as of the date of his death. See Q&A d-5 and d-6 of this section to determine the decedent's aggregate interest.

d-3: Q. Does the special grandfather rule apply for purposes of determining the amount of the decedent's excess accumulation?

A. Yes. If a decedent prior to death (or the decedent's personal representative after death) makes an election that satisfied the procedures in Q&A b-3 of this section, the special grandfather rule applies.

d-4: Q. How is the decedent's excess accumulation determined if the special grandfather rule applies?

A. If the special grandfather rule applies, the decedent's excess accumulation is the excess of (a) the decedent's aggregate interest (determined under Q&A d-5 of this section) over (b) the greater of (1) the decedent's remaining unrecovered grandfather amount as of the date of the decedent's death, or (2) an amount equal to the present value of a hypothetical life annuity under Q&A d-7 of this section.

d-5. Q. How is the value of the decedent's aggregate interest as of the applicable valuation date under Q&A d-2 determined?

A. (a) *Method of valuation.* The value of the decedent's aggregate interest on the decedent's date of death is determined in a manner consistent with the valuation of such interests for purposes of determining the individual's gross estate for purposes of chapter 11. If the personal representative for an individual's estate subject to estate tax elects to value the property in the gross estate under section 2032, the decedent's aggregate interest is valued in a manner consistent with the rules prescribed by section 2032 (and other relevant estate tax sections). No adjustments provided in chapter 11 in valuing the gross estate are made. Thus, there is no adjustment under section 2057 (relating to the sale of certain employer securities).

(b) *Amounts included.* Generally, all amounts payable to beneficiaries of the decedent under any qualified employer plan (including amounts payable to a surviving spouse under a qualified joint and survivor annuity or qualified preretirement survivor annuity) or individual retirement plan, whether or not otherwise included in valuing the decedent's gross estate, are considered to be part of the decedent's interest in such plan.

(c) *Rollover after death.* If any amount is distributed from a qualified employer plan or individual retirement plan within the 60-day period ending on the decedent's date of death and is rolled over to an IRA after such date but within 60 days of the date distributed, the decedent's aggregate interest is increased by the amount rolled over, valued as of the date received by the IRA.

d-6: Q. Are there any reductions in the decedent's aggregate interest?

A. The decedent's aggregate interest is reduced by the following:

(a) *Amount payable to alternate payee.* The amount of any portion of the deceased individual's interest in a qualified employer plan that is payable to an alternate payee in whose income the amount is includible under a qualified domestic relations order with the meaning of section 414(p) (QDRO). However, such portion must be taken into account in determining the excess distribution or the excess accumulation upon the death of such alternate payee for purposes of determining if there is a tax under section 4981A(a) or an increase in the estate tax under section 4981A(d) with respect to such alternate payee.

(b) *Investment in the contract.* The amount of the deceased individual's unrecovered investment, within the meaning of section 72(f), in any qualified employer plan or individual retirement plan.

(c) *Life insurance proceeds.* The excess of any amount payable by reason of the death of the individual under a life insurance contract held under a qualified employer plan over the cash surrender value of such contract immediately before the death of such individual (the amount excludible from income by reason of section 101(a)). Amounts excludible from gross income because of section 101(b) do not reduce the decedent's aggregate interest.

(d) *Interest as a beneficiary.* The amount of the deceased individual's interest in a qualified retirement plan or individual retirement plan by reason of the death of another individual.

d-7: Q. How is the present value of the hypothetical life annuity determined?

A. (a) *General rule.* The hypothetical life annuity is a single life annuity contract that provides for equal annual annuity payments commencing on the decedent's date of death for the life of an individual whose age is the same as the decedent's determined as of the date of the decedent's death. The amount of each annual payment is equal to the greater of $150,000 (unindexed) and $112,500 (as indexed until the date of death). If the decedent elected (or the decedent's personal representative elects) the special grandfather rule, the amount of each annual payment is $112,500 (as indexed until the date of death) even if there is no remaining grandfather amount.

(b) *Determination of age.* The decedent's age as of the decedent's date of death for purposes of valuing the hypothetical life annuity is the decedent's attained age (in whole years) as of the decedent's date of death. For example, if the decedent was born on February 2, 1930, and died on August 3, 1990, the decedent's age for purposes of valuing the hypothetical life annuity is 60.

(c) *Interest rate assumptions.* The present value of the single life annuity described above must then be calculated using the interest rate and mortality assumptions in §20.2031-7 of the Estate Tax Regulations in effect on the date of death.

d-8: Q. Are any credits, deductions, exclusions, etc. that apply for estate tax purposes allowable as an offset against the excise tax under section 4981A(d) for excess accumulations?

A. No. No credits, deductions, exclusions, etc. that apply for estate tax purposes are allowed to offset the tax imposed under section 4981A(d). Thus, no credits under section 2010 through 2016 or other reductions permitted by Chapter 11 are allowable against the tax under section 4981A(d) for excess accumulations. For example, no credits are allowable for the unified credit against the estate tax, for state death taxes, or for gift taxes.

d-8A. Q. Is the estate liable for the excise tax of 15 percent on the amount of the decedent's excess accumulations?

A. Yes. In all events, the estate is liable for the excise tax of 15 percent on the amount of the decedent's excess accumulations. Transferee liability rules under chapter 11 do apply, however. Similarly, the reimbursement provisions of section 2205 also apply. Additionally, the rules generally applicable for purposes of determining the apportionment of the estate tax apply to the apportionment of the excise tax under section 4981A(d). Thus, the decedent's will or the applicable state apportionment law may provide that the executor is entitled to recover the tax imposed under section 4981A(d) attributable to any property from the beneficiary entitled to receive such property. However, absent such a provision in the decedent's will or in the applicable state apportionment law, the executor is not entitled to recover the tax imposed under section 4981A(d) attributable to any property from the beneficiary entitled to receive such property.

d-9: Q. How is the additional tax computed with respect to a decedent's estate under section 4981A(d)?

A. The determination of the additional tax under section 4981A(d) is illustrated by the following examples:

Example 1. (a) An individual (A) dies on February 1, 199X at age 70 and 9 months. As of A's date of death, A has an interest in a defined benefit plan described in section 401(a) (Plan X). Plan X has never provided for employee contributions. A has no section 72(f) investment in Plan X. A does not have any interest in any other qualified employer plan or individual retirement plan. The alternate valuation date in section 2032 does not apply. A did not elect to have the special grandfather rule apply. A's interest in Plan X is in the form of a qualified joint and survivor annuity. The value of the remaining payments under the joint and survivor annuity as of A's date of death (determined under D-5) is $2,000,000.

(b) Because A is age 70 and 9 months on A's date of death, A's life expectancy as of A'd date of death is calculated using age 70 (A's attained age in whole years on A's date of death). The factor from Table A of §20.2031-7(f) used to determine the present value of a single life annuity for an individual age 70 is 6.0522. The greater of $150,000 or $112,500 indexed for 199X is 150,000. The present value of the hypothetical single life annuity is $907,830 ($150,000 × 6.0522)

(c) The amount of A's excess accumulation is $1,092,170, determined as follows: $2,000,000 (value of A's interest in Plan X) minus $907,830 (value of hypothetical single life annuity contract) equals $1,092,170.

(d) The increase in the estate tax under section 4981A(d) is $163,825 (15 percent of $1,092,170).

Example 2. (a) The facts are the same as in *Example 1*, except that A's interest in Plan X consists of the following:

(1) $2,000,000, value of employer-provided portion of a qualified joint and survivor annuity determined as of A's date of death using the interest and mortality assumptions in §20.2031-7.

(2) $200,000, proceeds of a term life insurance contract (no cash surrender value before death).

(3) $100,000. amount (employer-provided portion) payable to A's former spouse pursuant to a QDRO.

(4) $100,000, amount of A's investment in Plan X.

(b) The value of A's interest in Plan X for purposes of calculating A's excess accumulation is still $2,000,000. The proceeds of the term life insurance contract, the amount payable under the QDRO, and the amount of A's investment in Plan X are excluded from such value.

Example 3. (a) The facts are the same as in *Example 1*, except that A elected the special grandfather rule. A's initial grandfather amount was $1,100,000. As of A's date of death, A had received $500,000 in distributions that were treated as a return of A's grandfather amount. Thus, A's unused grandfather amount is $600,000 ($1,100,000 - $500,000). In 199X, assume that $112,500 indexed is still $112,500.

(b) A's excess retirement accumulation is determined as follows: $2,000,000 minus the greater of (1) $600,000 or (2) the present value of a period certain annuity of $112,500 a year for 16 years. The present value of a single life annuity of $112,500 a year for an individual age 70 is determined as follows: $112,500 × 6.0522 = $680,827.25. $680,827.25 is greater than $600,000. Thus the amount of the excess retirement accumulation is $1,319,173 ($2,000,000 minus $680,827).

(c) The additional estate tax under section 4981A(d) is $197,875 (15 percent of $1,319,173).

Example 4. (a) The facts are the same as in *Example 3* except that, as of A's date of death, A received $90,000 in distributions that were treated as a return of A's grandfather amount. Thus, A's unused grandfather amount is $1,010,00 ($1,100,000 - $90,000).

(b) A's excess retirement accumulation is determined as follows: $2,000,000 minus the greater of (1) ($1,010,000 (A's unused grandfather amount) or (2) 680,827.25 (the present value of a single life annuity of $112,500 a year for an individual age 70). A's unused grandfather amount is greater than the present value of the hypothetical life annuity. Thus, the amount of the excess retirement accumulation is $990,000 ($2,000,000 - $1,010,000).

(c) The additional estate tax under section 4981A(d) is $148,500 (15 percent of $990,000).

d-10: Q. If a surviving spouse rolls over a distribution from a qualified retirement plan or an individual retirement plan of the decedent to an individual retirement plan (IRA) established in the spouse's own name, is any distribution in a calendar year from the IRA receiving such rollover included in determining the spouse's excess distribution or excess accumulation in such calendar year?

A. (a) *General rule.* If a surviving spouse rolls over a distribution from a qualified retirement plan or an individual retirement plan of the decedent to an individual retirement plan (IRA) established in the spouse's own name with the rollover contribution and no other contributions or transfers are made to the IRA receiving the rollover contribution, distributions from such IRA will be excluded in determining the spouse's excess distributions and the value of the IRA will be excluded in determining the spouse's excess accumulation. If the surviving spouse rolls over a distribution from a qualified retirement plan or IRA of the decedent to an IRA for which the spouse has prior contributions or makes additional contributions to the IRA receiving the distribution, distributions from the IRA will be included in determining the amount of the excess distributions received by the spouse for the calendar year of the distribution and the value of the IRA at the applicable valuation date will be included in determining the spouse's excess accumulation.

(b) *Special rules.* The rule in paragraph (a) of this Q&A d-10 also applies if a surviving spouse elects to treat an inherited IRA (described in section 408(d)(3)(C)(ii)) as the spouse's own IRA as long as the surviving spouse makes no further contributions to such IRA

(c) *Other beneficiaries.* Rules similar to the rules in paragraphs (a) &

(b) shall apply to an individual who elected to treat an IRA as subject to the distribution requirements of section 408(a)(6), prior to amendment by section 521(b) of TRA '84 [1984–3 C.B. (Vol. 1) 1, 373], under §1.408-2(b)(7)(ii) of the Income Tax Regulations.

d-11. Q. To what estates does the excise tax under section 4981A(d) apply?

A. The excise tax under section 4981A(d) applies to estates of decedents dying after December 31, 1986.

d-12: Q. Is the aggregate interest reduced by distributions described in paragraph (b)(1) of Q&A c-6 of this section (distributions prior to January 1, 1988, made on account of certain terminations of a qualified employer plan) which are made after the individual's death.

A. Yes, the value of the individual's aggregate interest determined under Q&A d-5 of this section is reduced by distributions described in paragraph (b)(1) of Q&A c-6 of this section which are made after the individual's death.

OPM CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT [26 CFR PART 602]

Par. 3. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. Section 602.101 is amended by inserting in the appropriate places in the table, "54.4981A-1T . . . 1545-0203".

There is a need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impractical to issue this Treasury decision with notice and public procedure under subsection (b) or section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

This Treasury decision is issued under the authority contained in sections 4981A and 7805 of the Internal Revenue Code of 1954 (100 Stat. 2481, 26 U.S.C. 4981A; 68A Stat. 917, 26 U.S.C. 7805).

Lawrence B. Gibbs,
Commissioner of Internal Revenue

Approved: November 23, 1987

O. Donaldson Chapoton,
Assistant Secretary of the Treasury

(Filed by the Office of the Federal Register on December 9, 1987, 8:45 a.m., and published in the issue of the Federal Register for December 10, 1987, 52 F.R. 46747 as corrected in 53 F.R. 18974).

Section 4982.—Excise Tax on Undistributed Income of Regulated Investment Companies

If a regulated investment company that is also a personal holding company retains income, and thus has investment company taxable income and undistributed personal holding company income, is the company liable for tax under both section 541 and 852(b)(1) of the Code? See Rev.Rul. 88-41, page 253.

Chapter 45.—Windfall Profit Tax on Domestic Crude Oil
Subchapter C.—Miscellaneous Provisions

Section 4996.—Other Definitions and Special Rules

26 CFR 51.4996-1: Definitions.

T.D. 8185

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER D, PART 51—EXCISE TAX REGULATIONS UNDER THE CRUDE OIL WINDFALL PROFIT TAX ACT OF 1980

Newly Discovered Oil

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final excise tax regulations relating to the definition of the term "newly discovered oil" for purposes of the windfall profit tax. Changes to the applicable tax law were made by the Crude Oil Windfall Profit Tax Act of 1980, by the Economic Recovery Tax Act of 1981, and by the Tax Reform Act of 1986. The final regulations provide guidance on the requirements for the qualification of crude oil as newly discovered oil, as well as a definition of production in "commercial quantities" that affects the definition of property, the net income limitation on windfall profit, and the exemption for Alaskan oil.

DATES: The final regulations are effective with respect to all crude oil removed (or deemed removed) from the premises after February 29, 1980.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On November 5, 1982, the FEDERAL REGISTER published proposed amendments to the Excise Tax Regulations Under the Crude Oil Windfall Profit Tax Act of 1980 (26 CFR Part 51) under sections 4988, 4991, and 4996 of the Internal Revenue Code of 1954 (47 FR 50306). The amendments were proposed to conform the regulations to section 101(a)(1) of the Crude Oil Windfall Profit Tax Act of 1980 (94 Stat. 230). A public hearing was held on April 12, 1983. After consideration of all comments regarding the proposed amendments, those amendments are adopted as revised by this Treasury decision.

EXPLANATION OF PROVISIONS

Commercial quantities—in general.

The Conference Committee Report accompanying the Crude Oil Windfall Profit Tax Act of 1980 (Rep. No. 817, 96th Cong., 2d Sess. 97-8 (1980)) stated that it was the intention of the Committee that the term "newly discovered oil" should include production from a property that did not produce crude oil in commercial quantities in calendar year 1978. The report stated that this included production from a property on which oil was produced in 1978 if that 1978 production was incident to the drilling of exploratory or test wells and was not part of continuous or commercial production.

The proposed regulations defined crude oil produced in "commercial quantities" as any crude oil production (1) sold or exchanged or (2) retained for beneficial economic use by the operator or by any producer. However, crude oil produced incident to the drilling of an exploratory well (including a test well) was to be disregarded. The proposed regulations also provided that in no case would crude oil produced from a well after its casing, including the so-called "Christmas tree," had been installed be considered to be crude oil produced incident to such drilling.

Comments submitted with respect to the proposed rule pointed out that the rule did not conform to industry practices. In many instances installation of casing and a flow control device are required in order to comply with environmental and conservation practices, and such installation is not necessarily evidence of the termination of the "exploration" phase. As a result, the final regulations modify the position taken in the proposed regulations by adopting the rule stated in the conference report. Under this rule, the determination of each particular case is based solely on the facts and circumstances of that case.

Commercial quantities—newly discovered oil.

For the purpose of defining the term "newly discovered oil," the Tax Reform Act of 1986 clarifies the "exploratory well" exception described in the Conference Committee Report accompanying the Crude Oil Windfall Profit Tax Act of 1980. The 1986 Act provides that the term "newly discovered oil" includes production from a property that produced crude oil in calendar year 1978 if (1) not more than 2,200 barrels was produced from the property in that year, and (2) no well on the property was in production for more than 72 hours during that year. For the purpose of this test, it is irrelevant whether or not the 1978 crude oil production was sold or exchanged, or was retained for beneficial economic use. Also, for the purpose of the second requirement of this test, a dual completion well is treated as two separate wells (*i.e.*, one well for each horizon). The final regulations incorporate this test.

New lease.

The proposed regulations provided that crude oil produced from a new lease on the Outer Continental Shelf would qualify as newly discovered oil. The term "new lease" was defined as a lease entered into on or after January 1, 1979, of submerged acreage that did not produce crude oil in commercial quantities in calendar year 1978. Consequently, the proposed regulations provided that a lease would be denied new lease status if any portion of its submerged acreage was included at any time during 1978 in a lease on the Outer Continental Shelf whose submerged acreage produced crude oil in commercial quantities in calendar year 1978. Some commentators urged that the final regulations should adopt the on-shore property rules and define the term "newly discovered oil" to include crude oil produced from new reservoirs on Outer Continental Shelf leases entered into before 1979.

The final regulations adopt the Outer Continental Shelf rules as proposed in the notice. Section 4991(e)(2) provides that the term "newly discovered oil" has the meaning given to such term by the June 1979 energy regulations. Under the June 1979 energy regulations, the determination of whether or not Outer Continental Shelf production is treated as newly discovered oil is based on the new lease concept. Unlike the commercial quantities rule, the committee reports did not indicate an intention to depart from the June 1979 energy regulations. Indeed, all references in the legislative history to Outer Continental Shelf production assume that the definition of newly discovered oil provided in the June 1979 energy regulations would remain unchanged in that regard. Consequently, the final regulations provide that newly discovered oil produced from the Outer Continental Shelf is classified only on a lease basis.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that a Regulatory Impact Analysis is not required because this final rule is not a major rule under Executive Order 12291.

The Commissioner of Internal Revenue has concluded that this final regulation is interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, this final regulation is a regulation not subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

* * * * *

Adoption of amendments to the regulations

The amendments to 26 CFR Part 51 are hereby adopted as set forth below:

Paragraph 1. The authority citation for Part 51 continues to read in part:

Authority: 26 U.S.C. 4997, 7805.***

Par. 2. Section 51.4996-1 is amended by redesignating paragraph (m) as paragraph (o) and by inserting immediately after paragraph (l) new paragraphs (m) and (n), to read as follows:

§51.4996-1 Definitions.

* * * * *

(m) *Newly discovered oil.*—(1) *In general.* The term "newly discovered oil" means taxable crude oil that either is produced from a newly discovered crude oil property or is imputed newly discovered oil from a unitized property.

(2) *Newly discovered crude oil property.* The term "newly discovered crude oil property" means—

(i) A new lease on the Outer Continental Shelf; or

(ii) A property (not on the Outer Continental Shelf) that did not produce crude oil in commercial quantities in calendar year 1978; or

(iii) Any unitized property that is made up entirely of leases described in paragraph (m)(2)(i) of this section or properties described in paragraph (m)(2)(ii) of this section, or both.

(3) *Imputed newly discovered oil.* (Reserved)

(4) *New lease.* The term "new lease" means any lease of submerged acreage that satisfied all of the following three requirements:

(i) It was entered into on or after January 1, 1979;

(ii) Its submerged acreage did not produce crude oil in commercial quantities in calendar year 1978; and

(iii) No portion of its submerged acreage was included at any time during 1978 in a lease on the Outer Continental Shelf whose submerged acreage produced crude oil in commercial quantities in calendar year 1978.

Determinations under paragraph (m)(4)(i) of this section of the date on which a lease was entered into shall be made without regard to any extension, renewal, modification, assignment, or sublease of the lease. Accordingly, the original date on which that lease was entered into is controlling for purposes of that paragraph.

(5) *Outer Continental Shelf.* The term "Outer Continental Shelf" means Outer Continental Shelf as defined by section 2(a) of the Outer Continental Shelf Lands Act (43 U.S.C. 1331(a)).

(6) *Production in commercial quantities in 1978.* A property (or submerged acreage on the Outer Continental Shelf) produced crude oil in commercial quantities in calendar year 1978 if any crude oil that was produced in calendar year 1978 (other than crude oil production that is disregarded under paragraph (n) of this section because it was incidental to the drilling of an exploratory well, including a test well, and was not part of continuous or commercial production) from that property (or submerged acreage) ultimately was sold or exchanged or was retained for beneficial economic use. However, a property (or submerged acreage) shall be treated as not producing crude oil in commercial quantities in calendar year 1978 if, during calendar year 1978, both of the following requirements are met:

(i) The aggregate amount of crude oil produced from the property (or submerged acreage) did not exceed 2,200 barrels, and

(ii) No well on the property (or submerged acreage) was in production for a total of more than 72 hours.

For the purposes of paragraph (m)(6)(i) and (ii) of this section, it is irrelevant whether or not the crude oil produced was sold or exchanged or was retained for beneficial economic use. In addition, for the purpose of paragraph (m)(6)(ii) of this section, a dual completion well shall be treated as two separate wells (*i.e.*, one well for each horizon).

(n) *Commercial quantities.* Crude oil is produced in commercial quantities if any of the crude oil produced is—

(1) Sold or exchanged; or

(2) Retained for beneficial economic use (*e.g.*, to power any production equipment or to inject into a well). However, crude oil production that is incidental to the drilling of an exploratory well (including a test well), and that is not part of continuous or commercial production, shall be disregarded. Whether crude oil production is incidental to such drilling and is not part of continuous or commercial production shall be determined on the basis of all the facts and circumstances of the particular case.

(o) *Other.****

Par. 3. Paragraph (b) of §51.4991-1 is amended by revising the sixth sentence to read as follows:

§51.4991-1 Taxable crude oil; tiers of oil.

* * * * *

(b) *Tiers of oil.**** The term "newly discovered oil" has the meaning given to that term in §51.4996-1(m).***

Par. 4. Section 51.4988-2 is amended by adding at the end of paragraph (b)(3)(iii) a sixth sentence to read as follows:

§51.4988-2 Net income limitation on windfall profit.

* * * * *

(b) *Calculation of net income limitation.****

(3) *Taxable income from the property reduced by cost depletion*

* * * * *

(iii) ***See paragraph (n) of §51.4996-1 for the definition of the term "commercial quantities."

* * * * *

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved February 12, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 1, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 2, 1988, 53 F.R. 6626)

Subtitle F.—Procedure and Administration
Chapter 61.—Information and Returns
Subchapter A.—Returns and Records
Part III.—Information Returns
Subpart A.—Information Concerning
Persons Subject to Special Provisions

Section 6036.—Notice of Qualification as Executor or Receiver

26 CFR 301.6036-1: Notice required of executor or of receiver or other like fiduciary.

T.D. 8172

TITLE 26.—INTERNAL REVENUE CHAPTER 1, SUBCHAPTER F, PART 301—PROCEDURE AND ADMINISTRATION

Procedure and Administration—Notice of Qualification of Trustee or Like Fiduciary in Bankruptcy

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations eliminating a requirement that a bankruptcy trustee, debtor in possession or like fiduciary in a bankruptcy proceeding give notice of appointment or authority to act.

DATES: These regulations are effective as of January 29, 1988.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains an amendment to the Procedure and Administration Regulations (26 CFR Part 301) under section 6036 of the Code. This amendment is issued under the authority contained in sections 6036 and 7805 of the Code (68A Stat. 744; 26 U.S.C. 6036; 68A Stat. 917; 26 U.S.C. 7805).

EXPLANATION OF PROVISION

Section 6036 provides that every receiver, bankruptcy trustee, or like fiduciary or executor shall give notice of his qualifications to the Secretary of the Treasury as provided by regulations. The Secretary may provide exemptions from this notice requirement as he deems proper.

Section 301.6036-1(a)(1), before amendment by this document, required receivers, bankruptcy trustees, debtors in possession and other like fiduciaries in a bankruptcy proceeding to provide the appropriate district director with notice of appointment within 10 days of the date thereof. Notice was not required, however, if it had been given to the Secretary or other Treasury official under any provision of title 11 of the United States Code.

The amendment adopted by this document eliminates the notice requirement under section 6036 for bankruptcy trustees, debtors in possession and other like fiduciaries in a bankruptcy proceeding. This is because the Internal Revenue Service has determined that the notice requirements contained in the Bankruptcy Rules are sufficient for its purposes.

EXECUTIVE ORDER 12291 AND REGULATORY FLEXIBILITY ACT

The Commissioner of Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for final regulations subject to 5 U.S.C. 553(b)(B). Accordingly, the final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

LIST OF SUBJECTS IN 26 CFR 301

Administrative practice and procedure, Bankruptcy, Courts, Crime, Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Investigations, Law enforcement, Penalties, Pensions, Statistics, Taxes, Disclosure of information, Filing requirements.

Adoption of amendments to the regulations.

Accordingly, 26 CFR Part 301 is amended as follows:

Paragraph 1. The authority citation for part 26 is amended by adding the following citation:

Authority: 26 U.S.C. 7805; *** §301.6036-1 also issued under 26 U.S.C. 6036.

Par. 2. Section 301.6036-1 is amended by revising paragraph (a)(1), so much of paragraph (a)(4)(i) as precedes subdivision (*a*), and paragraph (e) as follows:

§301.6036-1. Notice required of executor or of receiver or other like fiduciary.

(a) *Receivers and other like fiduciaries.* (1) *Exemption for bankruptcy proceedings.* (i) A bankruptcy trustee, debtor in possession or other like fiduciary in a bankruptcy proceeding is not required by this section to give notice of appointment, qualification or authorization to act to the Secretary or his delegate. (However, see the notice requirements under the Bankruptcy Rules.)

(ii) Paragraph (a)(1)(i) of this section is effective for appointments, qualifications and authorizations to act made on or after January 29, 1988. For appointments, qualifications and authorizations to act made before the foregoing date, 26 CFR 301.6036-1(a)(1) and (4)(i) (revised as of April 1, 1986) apply.

* * * * *

(4) *Contents of Notice*—(i) *Proceedings other than bankruptcy.* The written notice required under paragraph (a)(2) of this section shall contain—

* * * * *

(e) *Applicability.* Except as provided in paragraph (a)(1)(ii) of this section, the provisions of this section shall apply to those persons referred to in this section whose appointments, authorizations, or assignments occur on or after the date of publication of these regulations in the Federal Register as a Treasury decision.

* * * * *

This Treasury decision merely eliminates a requirement that a bankruptcy trustee, debtor in possession, or like fiduciary in a bankruptcy proceeding give notice of appointment or authority to act. For this reason, it is found unnecessary to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved January 14, 1988.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on January 28, 1988, at 8:45 a.m., and published in the issue of the Federal Register for January 29, 1988, 52 F.R. 2599).

Subpart B.—Information Concerning Transactions With Other Persons

Section 6041.—Information At Source

26 CFR 1.6041-1: Return of information as to payments of $600 or more.
(Also Section 3406; 35a.9999-2)

Information reporting; rental assistance payments. Rental assistance payments made by public housing agencies to owners of authorized housing projects are subject to information reporting under section 6041 of the Code.

Rev. Rul. 88-53

ISSUE

Are rental assistance payments made by public housing agencies to owners of authorized housing projects subject to information reporting under section 6041 of the Internal Revenue Code?

FACTS

Under section 8 of the United States Housing Act of 1937, as amended (Act), 42 U.S.C. section 1437f (1982), the United States Department of Housing and Urban Development (HUD) administers a program that provides rental assistance payments for lower-income families. HUD authorizes public housing agencies to administer various aspects of the program. Section 3(6) of the Act, as amended, 42 U.S.C. section 1437a(b)(6)(1982), defines the term "public housing agency" to mean any state, county, municipality, or other governmental entity or public body (or agency or instrumentality thereof) that is authorized to engage in or assist in the development or operation of lower income housing. The rental assistance payments are made by HUD to public housing agencies that, in turn, make the payments to the owners of the housing projects. Many of the housing projects are owned by individuals.

LAW AND ANALYSIS

Section 6041(a) of the Code (with exceptions not here applicable) provides that all persons engaged in a trade or business and who make payments in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensation, remuneration, emoluments, or other fixed or determinable gains, profits and income, of $600 or more in any taxable year must file an information return showing the amount of such gains, profits, and income, and the name and address of the recipient. Section 6041(d) provides that every person required to make a return under section 6041(a) shall furnish a written statement to the payee.

Section 1.6041-1(a)(1)(ii) of the Income Tax Regulations requires every person engaged in a trade or business to make an information return reporting payments made in the course of the trade or business to another person of fixed or determinable interest, rents, royalties, annuities, pensions, and other gains, profits, and income aggregating $600 or more in a calendar year unless such payments are specifically excluded from the reporting requirements under section 1.6041-3. Section 1.6041-3(c) specifically excludes from the reporting requirements payments made to most corporations.

Section 1.6041-1(b) of the regulations defines the term "all persons engaged in a trade or business" as used in section 6041(a) of the Code to include not only those so engaged for gain or profit, but also organizations the activities of which are not for the purpose of gain or profit, for example, the organizations referred to in paragraph (g) of section 1.6041-1.

Section 1.6041-1(g) of the regulations requires that information returns on Forms 1099 of payments made by the United States or a state, or political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing, shall be made by the officer or employee of the United States, or of such state, or political subdivision, or of the District of Columbia, or of such agency or instrumentality, as the case may be, having control of such payments or by the officer or employee appropriately designated to make such returns.

Under section 3406 of the Code, a payee is subject to backup withholding of 20 percent on payments of a kind required to be shown on a return required under section 6041(a) if the payee fails to furnish the payee's taxpayer identification number (TIN) in the required manner or the Internal Revenue Service notifies the payor that the TIN furnished by the payee is incorrect, and any one of the following three conditions exists: (1) payments to the payee aggregate $600 or more during the calendar year; (2) the payor was required to file a return with respect to payments under section 6041(a) for the preceding calendar year; or (3) the payor was required to impose backup withholding on payments made to the payee during the preceding calendar year. Payments to payees who are not subject to reporting requirements under section 1.6041-3 of the regulations are not subject to backup withholding. Section 3406(b)(3) of the Code. Other payees, such as organizations exempt from taxation under section 501(a), are also not subject to backup withholding. Section 3406(g), and section 35a.9999-3, Q. & A. 13 of the Temporary Employment Tax Regulations.

In the instant case, the public housing agencies as defined in section 3(6) of the Act are organizations described in section 1.6041-1(g) of the Income Tax Regulations. Such public housing agencies are therefore "persons engaged in a trade or business" as defined in section 1.6041-1(b). The payments made by the public housing agencies are payments made in furtherance of the purpose for which the organizations are formed and are therefore payments made in the course of the trade or business of those organizations.

HOLDING

The rental assistance payments that aggregate $600 or more made by the public housing agencies to noncorporate owners of housing projects are subject to information reporting under sections 6041(a) and (d) of the Code. Forms 1099-MISC, Statements for Recipients of Miscellaneous Income, must be filed, and written statement must be furnished to the recipients by the officer or employee of the public housing agency having control of the rental assistance payments or by the officer or employee appropriately designated to make such returns.

In addition, the public housing agencies are required to impose backup withholding under section 3406 of the Code on payments made to payees who are subject to backup withholding and to report amounts withheld on Forms 1099-MISC and on the written statements furnished to the recipients.

---

26 CFR 1.6041-1: Return of information as to payments of $600 or more.

Printing of substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 88-28, page 804.

---

26 CFR 1.6041-3: Payments for which no return of information is required under section 6041.

T.D. 8193

TITLE 26—INTERNAL REVENUE.
CHAPTER 1, SUBCHAPTER A,
PART 1—INCOME TAX; TAXABLE
YEARS BEGINNING AFTER
DECEMBER 31, 1953

Exemption For Certain Non-Profit Organizations From Filing Information Returns When Paying Awards of $600 or More to Informants

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide an exception for certain non-profit organizations from filing information returns when paying awards of $600 or more to informants.

DATES: The regulations are effective January 1, 1988, and shall apply to information return filing requirements with respect to award payments made after December 31, 1987.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains final regulations under section 6041 of the Internal Revenue Code of 1954 to provide an exemption for certain section 501(c)(3) organizations from the reporting requirements of section 6041. It was determined that no notice and public comment procedure is necessary since this document will not be detrimental to any taxpayer.

EXPLANATION OF PROVISIONS

Section 6041 requires a person engaged in a trade or business, who pays compensation of $600 or more to another person, to provide an information return to the Secretary describing the transaction to such extent as may be provided by the Secretary. Section 1.6041-3(n) currently provides that the United States, a State, Territory, or political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing is exempt from the reporting requirements of section 6041(a) with respect to a payment of a type determined by the Commissioner to be paid as an award to an informer or other payment of a similar character. This exemption allows informants to maintain confidentiality and aids the foregoing governmental entities in obtaining information in connection with law enforcement activities.

Certain non-profit organizations also pay awards to informants who provide information relating to criminal law enforcement. It is felt that the effectiveness of the programs of the non-profit organizations will be enhanced if these organizations are also exempt from the reporting requirements of section 6041(a) with respect to payments of awards.

In order to allow informants to maintain confidentiality and to enhance the effectiveness of informant programs, this Treasury decision amends §1.6041-3(n) to extend the exemption from the reporting requirements of section 6041(a) to certain section 501(c)(3) organizations with respect to payments of awards.

SPECIAL ANALYSES

A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for final regulations subject to 5 U.S.C. 553(b)(B). Accordingly, the final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The Commissioner of Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1 is amended as follows:

Paragraph 1. The authority for Part 1 continues to read in part:

Authority: 26 U.S.C. 7805. *** Section 1.6041-3 also issued under 26 U.S.C. 6041(a).

Par. 2. Section 1.6041-3(n) is revised to read as follows:

§1.6041-3 Payments for which no return of information is required under section 6041.

* * * * *

(n) A payment for an informer as an award, fee, or reward for information relating to criminal activity, but only if such payment is made by the United States, a State, Territory, or political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing, or, with respect to payments made after December 31, 1987, by an organization that is described in section 501(c)(3) and that makes such payments in furtherance of a charitable purpose to lessen the burdens of government within the meaning of §1.501(c)(3)-1(d)(2).

* * * * *

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved April 4, 1988.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on April 12, 1988, 8:45 a.m., and published in the issue of the Federal Register for April 13, 1988, 53 F.R. 12149)

Section 6041A.—Returns Regarding Payments of Renumerations for Services and Direct Sales

Printing of substitutes for Forms 1096, 1098, 1099, 5498 and W-2G. See Rev. Proc. 88-28, page 804.

Section 6042.—Returns Regarding Payments of Dividends and Corporate Earnings and Profits

26 CFR 1.6042-2: Returns of information as to dividends paid in calendar years after 1962.

Printing of substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 88-28, page 804.

Section 6043.—Returns Regarding Liquidation, Dissolution, Termination, or Contraction

Printing of substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 88-28, page 804.

Section 6044.—Returns Regarding Payments of Patronage Dividends

26 CFR 1.6044-2: Returns of information as to payments of patronage dividends with respect to patronage occurring in taxable years beginning after 1962.

Printing of substitutes for Forms 1096, 1098, 1099, 5498 and W-2G. See Rev. Proc. 88-28, page 804.

Section 6045.—Returns of Brokers

26 CFR 1.6045-1: Returns of information of brokers and barter exchanges.

Printing of substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 88-28, page 804.

Section 6047.—Information Relating to Certain Trusts and Annuity Plans

26 CFR 1.6047-1: Information to be furnished with regard to employee retirement plan covering an owner-employee.

Printing of substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 88-28, page 804.

Section 6049.—Returns Regarding Payments of Interest

26 CFR 1.6049-4: Return of information as to interest paid and original issue discount includible in gross income after December 31, 1982.

Printing of substitutes for Forms 1096, 1098, 1099, 5498 and W-2G. See Rev. Proc. 88-28, page 804.

Section 6050A.—Reporting Requirements of Certain Fishing Boat Operators

26 CFR 1.6050A-1: Reporting requirements of certain fishing boat operators.

Printing of substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 88-28, page 804.

Section 6050B.—Returns Relating to Unemployment Compensation

26 CFR 1.6050B-1: Information returns by person making unemployment compensation payments.

Printing of substitutes for Forms 1096, 1098, 1099, 5498 and W-2G. See Rev. Proc. 88-28, page 804.

Section 6050D.—Returns Relating to Energy Grants and Financing

26 CFR 1.6050D-1: Information returns relating to energy grants and financing.

Printing of substitutes for Forms 1096, 1098, 1099, 5498 and W-2G. See Rev. Proc. 88-28, page 804.

Section 6050E.—State and Local Income Tax Refunds

26 CFR 1.6050E-1: Reporting of State and local income tax refunds.

Printing of substitutes for Forms 1096, 1098, 1099, 5498 and W-2G. See Rev. Proc. 88-28, page 804.

Section 6050H.—Returns Relating to Mortgage Interest Received in a Trade or Business from Individuals

26 CFR 1.6050H-1T: Information reporting of mortgage interest received in a trade or business from individuals after 1985 and before 1988 (Temporary).

T.D. 8191

TITLE 26.—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER A, SUBCHAPTER H, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Returns Relating to Mortgage Interest Received in a Trade or Business From Individuals

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations and temporary regulations.

SUMMARY: This document contains final and temporary regulations relating to the reporting of mortgage interest received in a trade or business from individuals. The Tax Reform Acts of 1984 and 1986 changed the applicable law. The final regulations affect a person that is engaged in a trade or business and that, in the course of that trade or business, receives $600 or more of mortgage interest from an individual for a calendar year. The final regulations provide these persons with guidance necessary to comply with the law.

EFFECTIVE DATE: The final regulations are effective on January 1, 1988, and apply to mortgage interest received after December 31, 1987.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On August 20, 1985, the Federal Register published temporary regulations (50 FR 33529) [T.D. 8047, 1985-2 C.B. 311] under section 6050H of the Internal Revenue Code relating to the reporting of mortgage interest received in a trade or business from individuals. The text of those temporary regulations also served as a notice of proposed rulemaking published in the Federal Register for the same day (50 FR 33551) [LR-214-84, 1985-2 C.B. 832].

Section 145 of the Tax Reform Act of 1984 (Pub. L. 98-369, 98 Stat. 685) added section 6050H to the Code. Section 6050H requires a person engaged in a trade or business to report receipt of at least $600 of mortgage interest from an individual for a calendar year if the interest is received in the course of the trade or business. Section 1811(a) of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2832) [1986-3 (Vol.1) C.B. 1, 749] made technical corrections to section 6050H. The final regulations reflect the relevant provisions of the 1984 and 1986 Acts.

After the Internal Revenue Service published temporary and proposed regulations, interest recipients noted their inability to comply with certain provisions. The Service's publication of Announcement 86-3, 1986-3 I.R.B. 42, relaxed several reporting requirements for interest received in 1985. Announcement 86-112, 1986-46 I.R.B. 22, clarified the application of Announcement 86-3 to interest received after 1985. The final regulations reflect the issues addressed in Announcement 86-3.

The Service received public comments on the proposed regulations and held a public hearing on January 7, 1986. After fully considering comments and statements made at the hearing, the Service adopts the proposed regulations as revised by this Treasury decision. Revisions to the proposed regulations are discussed below.

EFFECTIVE DATE

The final regulations are effective only for interest received after December 31, 1987. The temporary regulations and Announcements 86-3 and 86-112 apply to interest received before January 1, 1988.

POINTS AND OTHER PREPAID INTEREST

The proposed regulations prohibited an interest recipient from reporting points and other prepaid interest in the year of receipt but did not address when, if ever, to report those amounts. Announcement 86-3 provided that an interest recipient that received points and other prepaid interest in 1985 can report those amounts as received in 1985 if it was unable to segregate those amounts. Announcement 86-112 stated that the reporting requirement for points and other prepaid interest was relaxed only for 1985. The final regulations prohibit reporting of points and other prepaid interest in the year of prepayment, prohibit reporting of prepaid interest in the form of points in any year, and require reporting of prepaid interest other than points in the proper year of accrual.

Commentators suggested permitting an interest recipient to report in the current calendar year prepaid interest accruing shortly after year-end. For example, an interest payment properly accruing for the period December 6, 1988, through January 5, 1989, contains prepaid interest if received on December 31, 1988. The final regulations permit an interest recipient to report as interest received during the current calendar year prepaid interest properly accruing by the following January 15.

RULE OF 78s METHOD OF ACCOUNTING

The proposed regulations provided no special reporting rule for interest earned under the Rule of 78s method of accounting. Announcement 86-3 allowed an interest recipient that calculates interest earned under the Rule of 78s method of accounting to report interest received under that method provided it met certain notice requirements. The final regulations permit an interest recipient to report interest earned under the Rule of 78s method of accounting as interest received in circumstances identical to those described in Announcement 86-3.

DEFINITION OF MORTGAGE

The proposed regulations defined a mortgage as an obligation secured primarily by real property. Because commentators found difficulty in applying that definition, the final regulations define a mortgage as an obligation all or part of which is secured by real property. Real property includes a manufactured home meeting the definition of section 25(e)(10).

The proposed regulations exempted reporting for interest received on lines of credit or credit card obligations secured primarily by real property. Because the Tax Reform Act of 1986 limits interest deductibility and because payors of record are using these obligations more often, the final regulations remove this exemption.

The final regulations do not address issues arising out of the limitations on qualified residence interest.

The final regulations provide a transitional rule for obligations existing on December 31, 1987, that are not primarily secured by real property. An obligation covered by the transitional rule is not a mortgage subject to reporting after 1987.

INTEREST RECEIVED ON BEHALF OF ANOTHER PERSON

The proposed regulations required interest received on behalf of another person to be reported by the first person to receive it (the initial recipient). Commentators noted difficulty in compliance when the initial recipient did not possess the mortgage reporting information. Announcement 86-3 suspended this reporting rule for 1985 to allow initial recipients time to obtain the reporting information. Announcement 86-112 stated that Announcement 86-3 applied only to 1985 reporting. The final regulations require the initial recipient to report interest received on behalf of another person but except an initial recipient from reporting for any period for which the initial recipient does not possess the mortgage reporting information if the person for which the interest is received is engaged in a trade or business and would receive the interest in the course of its trade or business if it received the interest directly. The exception requires the person for which the interest is received, rather than the initial recipient, to report.

INTEREST RECEIVED BY FOREIGN PERSONS

The proposed regulations provided that a foreign-person interest recipient must report mortgage interest received outside the United States if it is a corporation such that any interest received from it would be from sources within the United States under section 861(a)(1)(C). The final regulations incorporate the criteria described in that section, extend the reporting requirements to noncorporate persons, and clarify that the term "foreign person" means "not a United States person" as defined in section 7701(a)(30).

INTEREST RECEIVED FROM NONRESIDENT ALIEN INDIVIDUALS

The proposed regulations did not exempt an interest recipient from reporting interest received from a nonresident alien individual. Announcement 86-3 provided that for 1985 an interest recipient need not report interest received from a nonresident alien individual. Announcement 86-112 extended this rule to post-1985 reporting. Announcement 86-3 provided documentary evidence rules to determine nonresident alien individual status. The final regulations except an interest recipient from reporting interest received from a nonresident alien individual in circumstances substantially similar to those described in Announcement 86-3.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291. Therefore, a regulatory impact analysis is not required.

Although the Service issued a notice of proposed rulemaking soliciting public comment, it concluded on issuing the notice that the regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, the final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The Service has submitted the collection-of-information requirements contained in these regulations to the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act of 1980. OMB has approved these requirements.

* * * * *

Adoption of amendments to the regulations

For the reasons set forth in the preamble, Title 26, Chapter 1, Subchapter A, Part 1, and Subchapter H, Part 602, of the Code of Federal Regulations is amended as set forth below:

INCOME TAX REGULATIONS (26 CFR Part 1)

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. *** Sections 1.6050H-0, 1.6050H-1, and 1.6050H-2 also issued under 26 U.S.C. 6050H.

Par. 2. Section 1.6050H-1T is amended by revising the title of such section to read as follows:

§1.6050H-1T Information reporting of mortgage interest received in a trade or business from individuals after 1985 and before 1988 (Temporary).

Par. 3. Section 1.6050H-1T is amended by revising Q/A-32 to read as follows:

Effective date

Q—32: When is this section effective?

A—32: This section generally is effective for mortgage interest received after December 31, 1984, and before January 1, 1988. However, Q/A-15a of this section is effective for mortgage interest received after December 31, 1986, and before January 1, 1988.

Par. 4. The following new sections are added immediately following §1.6050H-1T and read as follows:

§1.6050H-0 Table of contents.

§1.6050H-1 Information reporting of mortgage interest received in a trade or business from an individual.

- (a) Reporting requirement.
- (b) Qualified mortgage.
  - (1) In general.
  - (2) Mortgage.
    - (i) In general.
    - (ii) Transitional rule for certain obligations existing on December 31, 1984.
    - (iii) Transitional rule for certain obligations existing on December 31, 1987.
  - (3) Payor of record.
- (c) Interest recipient.
  - (1) Trade or business requirement.
  - (2) Interest received or collected on behalf of another person.
    - (i) General rule.
    - (ii) Exception.
  - (3) Examples
  - (4) Governmental unit.
- (d) Additional rules.
  - (1) Reporting by foreign person.
  - (2) Reporting with respect to nonresident alien individual.
    - (i) In general.
    - (ii) Nonresident alien individual status.
  - (3) Reporting by cooperative housing corporations.
- (e) Amount of interest received on mortgage for calendar year.
  - (1) In general.
  - (2) Calendar year.
    - (i) In general.
    - (ii) De minimis rule.
  - (3) Certain interest not received on mortgage.
    - (i) Interest received from seller on payor of record's mortgage.
    - (ii) Interest received from governmental unit.
  - (4) Interest calculated under Rule of 78s method of accounting.
- (f) [Reserved].
- (g) Effective date.

§1.6050H-2 Time, form, and manner of reporting interest received on qualified mortgage.

- (a) Requirement to file return.
  - (1) Form of return.
  - (2) Information included on return.
  - (3) Time and place for filing return.
  - (4) Use of magnetic media.
- (b) Requirement to furnish statement.
  - (1) In general.
  - (2) Information included on statement.
  - (3) Statement furnished pursuant to Federal mortgage program.
  - (4) Copy of Form 1098 to payor of record.
  - (5) Furnishing statement with other information reports.
  - (6) Time and place for furnishing statement.
- (c) Notice requirement for use of Rule of 78s method of accounting.
  - (1) In general.
  - (2) Time and manner.
- (d) Reporting by related parties.
  - (1) In general.
  - (2) Qualified person.
  - (3) Designation agreement.
  - (4) Penalties.
- (e) Penalty provisions.
  - (1) Failure to file return or to furnish statement.
  - (2) Failure to furnish TIN.
  - (3) Failure to include correct information.
- (f) Requirement to request and to obtain TIN.
  - (1) In general.
  - (2) Manner of requesting TIN.
- (g) Effective date.

§1.6050H-1 Information reporting of mortgage interest received in a trade or business from an individual.

(a) *Reporting requirement.* Except as otherwise provided in this section and §1.6050H-2, an interest recipient that receives at least $600 of interest on a qualified mortgage for a calendar year must, with respect to that interest—

(1) File an information return with the Internal Revenue Service; and

(2) Furnish a statement to the payor of record on the mortgage.

Paragraph (e) of this section contains rules to determine the amount of interest received on a mortgage for a calendar year. Section 1.6050H-2 contains rules relating to the form, time, and manner of filing information returns and furnishing statements. Paragraph (d) of this section contains additional rules relating to the reporting requirement for foreign persons, cooperative housing corporations, and nonresident alien individuals. An interest recipient may, but is not required to, report its receipt of less than $600 of interest on a qualified mortgage for a calendar year. An interest recipient that chooses, but is not required, to file a return as provided in §1.6050H-2(a) or to furnish a statement as provided in §1.6050H-2(b) is subject to this section and §1.6050H-2.

(b) *Qualified mortgage*—(1) *In general.* A mortgage is a qualified mortgage if the payor of record on the mortgage is an individual, including an individual acting in a capacity as a sole proprietor of a business. A mortgage is not a qualified mortgage if the payor of record on the mortgage is not an individual (such as a trust, estate, partnership, association, company, or corporation), even though an individual is a co-borrower on the mortgage and all the trustees, beneficiaries, partners, members, or shareholders of the payor of record are individuals.

(2) *Mortgage*—(i) *In general.* Except as otherwise provided in paragraphs (b)(2)(ii) and (b)(2)(iii) of this section, an obligation is a mortgage if real property (regardless of where located) secures all or part of the obligation. An interest recipient must determine whether real property secures an obligation at the time the obligation is created or, if security is added or removed at a later time, at that later time. Real property includes a manufactured home as defined in section 25(e)(10). An obligation includes a line of credit or a credit card obligation. For purposes of this section and §1.6050H-2, a borrower incurs

a line of credit or credit card obligation when the borrower first has the right to borrow against the line of credit or credit card, whether the borrower actually borrows an amount at that time. An obligation will not fail to be treated as a mortgage solely because, under an applicable State or local homestead law or other debtor protection law in effect on August 16, 1986, the security interest is ineffective or the enforceability of the security interest is restricted.

(ii) *Transitional rule for certain obligations existing on December 31, 1984*—(A) *In general.* An obligation that existed on December 31, 1984, is not a mortgage if, at the time the payor of record incurred the obligation, the interest recipient reasonably classified the obligation as other than a mortgage, real property loan, real estate loan, or other similar type of obligation. A reasonable classification of an obligation must be consistent with industry practices and determined according to the purpose of the obligation, the property securing the obligation, and any other reasonable factor. For purposes of this paragraph (b)(2)(ii)(A), an obligation was not reasonably classified as other than a mortgage, real property loan, real estate loan, or other similar type of obligation if, at the time the payor of record incurred the obligation, more than one-half of the obligations in the particular class in which the obligation was classified were secured primarily by real property.

(B) *Examples.* The following examples illustrate the rules of paragraph (b)(2)(ii)(A) of this section:

Example (1). B offers an unsecured line of credit and a line of credit secured by real property. B separately markets the two credit lines, and they are governed by different terms and conditions. For accounting purposes, B classifies the two types of loans as a single class. For purposes of paragraph (b)(2)(ii)(A) of this section, the two types of loans are different classes of obligations.

Example (2). B operates a program to make loans to small businesses. Depending on the amount of the loan and the credit history of the borrower, B may or may not require security for the loan. If B requires security, it may consist of real or personal property. For accounting purposes, B classifies all of the loans within this program as a single class. For purposes of paragraph (b)(2)(ii)(A) of this section, all of the loans within this program may be classified as belonging to a single class.

(iii) *Transitional rule for certain obligations existing on December 31, 1987.* An obligation that was incurred after December 31, 1984, and that existed on December 31, 1987, is not a mortgage if the obligation is not primarily secured by real property.

(3) *Payor of record.* A payor of record on a mortgage is the person carried on the books and records of the interest recipient as the principal borrower on the mortgage. If the books and records of the interest recipient do not indicate which borrower is the principal borrower, the interest recipient must designate a borrower as the principal borrower.

(c) *Interest recipient*—(1) *Trade or business requirement.* Except as provided in paragraph (c)(4) of this section, an interest recipient is a person that is engaged in a trade or business (whether or not the trade or business of lending money) and that, in the course of the trade or business, receives interest on a mortgage. For purposes of this paragraph (c)(1), if a person holds a mortgage which was originated or acquired in the course of a trade or business, the interest on the mortgage is considered to be received in the course of that trade or business. For example, if real estate developer A lends money to individual B to enable B to purchase a house in a subdivision owned and developed by A, and B gives a mortgage to A for the loan, A is an interest recipient for interest received on the mortgage. Alternatively, if C, a person engaged in the trade or business of being a physician, lends money to individual D to enable D to purchase C's home, and D gives a mortgage to C for the loan, C is not an interest recipient for interest received on the mortgage because C will not receive the interest in the course of the trade or business of being a physician.

(2) *Interest received or collected on behalf of another person*—(i) *General rule.* Except as otherwise provided in paragraph (c)(2)(ii) of this section, a person that, in the course of its trade or business, receives or collects interest on a mortgage on behalf of another person is the interest recipient (the initial recipient) for the mortgage. In this case, the reporting requirement of paragraph (a) of this section does not apply to the transfer of interest from the initial recipient to the person for which the initial recipient receives or collects the interest. For example, if financial institution A collects interest on behalf of financial institution B, A is the initial recipient for the mortgage, and B is not required to report the interest received on the mortgage from A.

(ii) *Exception.* Paragraph (c)(2)(i) of this section does not apply for a period for which—

(A) An initial recipient does not possess the information needed to comply with the reporting requirement of paragraph (a) of this section; and

(B) The person for which the interest is received or collected would receive the interest in the course of its trade or business if the interest were paid directly to that person.

The person for which the interest is received or collected is the interest recipient with respect to interest received or collected on the mortgage during such a period. For purposes of paragraph (c)(2)(ii)(B) of this section, if interest is received or collected on behalf of a person other than an individual, that person is presumed to receive interest in a trade or business.

(3) *Examples.* The following examples illustrate the rules of paragraph (c) of this section:

Example (1). Financial institution F collects mortgage interest on behalf of financial institution G and deposits the amount collected into G's account held with F. F possesses the information needed to comply with the reporting requirement of paragraph (a) of this section. F is the interest recipient for the mortgage. G is not required to report.

Example (2). The facts are the same as in example (1), except that F does not possess the information needed to comply with the reporting requirement. G, the person for which F collects the interest, is the interest recipient for the mortgage. F is not required to report.

Example (3). S, an individual, sells real property to another individual, P, and takes back a mortgage from P to finance the sale. S does not receive the interest in the course of a trade or business. B, a bank, collects P's payments of principal and interest on behalf of S and deposits that amount into an account held at the bank in S's name. B does not possess the information needed to comply with the reporting requirement of paragraph (a) of this section. B is the interest recipient for P's mortgage without regard to paragraph (c)(2)(ii) of this section, because S would not receive the interest in the course of a trade or business. S is not required to report.

Example (4). X collects mortgage interest on behalf of Y, who would receive the interest in the course of a trade or business. X possesses the information needed to comply with the reporting requirement of paragraph (a) of this section. On July 1. 1988, Z assumes X's interest collection responsibilities. Z does not possess the information needed to comply with the reporting requirement of paragraph (a) of this section. X is the interest recipient for interest received from January 1, 1988, through June 30, 1988. Because Z does not possess the requisite information and Y would receive the interest in the course of a trade or business, Y is the interest recipient for interest received from July 1, 1988, through December 31, 1988.

(4) *Governmental unit.* A governmental unit or an agency or instrumentality of a governmental unit that receives interest on a mortgage is an interest recipient without regard to the requirement of paragraph (c)(1) of this section that the interest be received in the course of a trade or business. A governmental unit or an agency or instrumentality of a governmental unit that is an interest recipient must designate an officer or employee to satisfy the reporting requirements of paragraph (a) of this section.

(d) *Additional rules*—(1) *Reporting by foreign person.* An interest recipient that is not a United States person (as defined in section 7701(a)(30)) must report interest received on a qualified mortgage only if it receives the interest—

(i) At a location in the United States, or

(ii) At a location outside the United States if the interest recipient is—

(A) A controlled foreign corporation (within the meaning of section 957(a)), or

(B) A person, 50 percent or more of the gross income of which, from all sources for the three-year period ending with the close of the taxable year preceding the receipt of interest (or for such part of the period as the person was in existence), was effectively connected with the conduct of a trade or business within the United States.

(2) *Reporting with respect to nonresident alien individual*—(i) *In general.* The reporting requirement of paragraph (a) of this section does not apply if—

(A) The payor of record is a nonresident alien individual, and

(B) Real property located in the United States does not secure the mortgage.

(ii) *Nonresident alien individual status.* For purposes of paragraph (d)(2)(i)(A) of this section, an interest recipient must apply the following documentary evidence rules to determine whether a payor of record is a nonresident alien individual:

(A) If interest is paid outside the United States, the interest recipient must satisfy the documentary evidence standard provided in §35a.9999-4T (Q/A-5(iii)) with respect to the payor of record; and

(B) If interest is paid within the United States, the interest recipient must secure from the payor of record a Form W-8 or a substantially similar statement signed by the payor under penalty of perjury as described in §1.6049-5(b)(2)(iv).

For purposes of this paragraph (d)(2)(ii), the place of payment is the place where the payor of record completes the acts necessary to effect payment. An amount paid by transfer to an account maintained by an interest recipient in the United States or by mail to a United States address is considered to be paid within the United States.

(3) *Reporting by cooperative housing corporations.* For purposes of this section and §1.6050H-2, an amount received by a cooperative housing corporation from an individual tenant-stockholder that represents the tenant-stockholder's proportionate share of interest described in section 216(a)(2) is interest received on a qualified mortgage in the course of the cooperative housing corporation's trade or business. A cooperative housing corporation is an interest recipient with respect to each tenant-stockholder's proportionate share of interest and must report $600 or more of interest received from an individual tenant-stockholder. The terms "cooperative housing corporation," "tenant-stockholder," and "tenant-stockholder's proportionate share" are defined in section 216 and the regulations thereunder.

(e) *Amount of interest on mortgage for calendar year*—(1) *In general.* For purposes of this section and §1.6050H-2, interest includes mortgage prepayment penalties and late charges other than late charges for a specific mortgage service. Interest does not include interest prepaid in the form of points, regardless of the payor of record's ability to deduct the points under section 461(g)(2). An interest recipient must not report interest prepaid in the form of points as interest received for any calendar year. For example, although an interest recipient receives $3,400 interest prepaid in the form of points in 1988, it must not report that interest in 1988 or a subsequent year. Whether an interest recipient receives $600 or more of interest on a mortgage for a calendar year is determined on a mortgage-by-mortgage basis. An interest recipient need not aggregate interest received on all of a payor of record's mortgages which it holds to determine if it meets the $600 threshold. Therefore, an interest recipient need not report interest of less than $600 received on a mortgage, even though it receives $600 or more of total interest on all of a payor of record's mortgages for a calendar year.

(2) *Calendar year*—(i) *In general.* Except as otherwise provided in paragraph (e)(2)(ii) of this section, the calendar year for which interest is received is the later of—

(A) The calendar year in which the interest is received, or

(B) The calendar year in which the interest properly accrues.

For example, if an interest recipient receives a payment on December 20, 1988, that includes interest accruing by December 31, 1988, the interest recipient must report the interest as received for 1988 even if the interest payment is not due until February 1989.

(ii) *De minimis rule.* An interest recipient may treat interest received during the current calendar year which properly accrues by January 15 of the subsequent calendar year as interest received for the current calendar year. For example, if an interest recipient receives a monthly interest payment on December 31, 1988, which includes interest accruing for the period December 5, 1988, to January 5, 1989, the interest recipient may treat the entire interest payment as received for 1988. If a portion of an interest payment received in a current calendar year accrues after January 15 of the subsequent calendar year, an interest recipient must report as interest received for the current calendar year only the portion that properly accrues by the end of the current calendar year. For example, if an interest recipient receives a monthly payment that includes interest accruing for the period December 20, 1988, through January 20, 1989, the interest recipient may not report as interest received for 1988 any interest accruing after December 31, 1988. The interest recipient must report the interest accruing after December 31, 1988, as received for calendar year 1989.

(3) *Certain interest not received on mortgage*—(i) *Interest received from seller on payor of record's mortgage.* Interest received from a seller or a person related to a seller within the meaning of section 267(b) or section 707(b)(1) on a payor of record's mortgage is not interest received on a mortgage. For example, interest is not received on a mortgage if a real estate developer deposits an amount in escrow with an interest recipient and advises it to draw on the account to pay interest on a payor of record's mortgage (e.g., a buy-down mortgage). Similarly, interest is not received on a mortgage if an interest recipient receives a lump sum from a real estate developer for interest on a payor of record's mortgage.

(ii) *Interest received from governmental unit.* Interest received from a governmental unit or an agency or instrumentality of a governmental unit is not interest received on a mortgage. For example, interest is not received on a mortgage if received as a housing assistance payment from the Department of Housing and Urban Development on a mortgage insured under section 235 of the National Housing Act (12 U.S.C. 1701-1715z (1982 & Supp. 1983)). Except as otherwise provided in paragraph (e)(1) and (2) of this section, interest received on a mortgage is only the excess of interest received on the mortgage over interest received from a governmental unit or an agency or instrumentality of a governmental unit.

(4) *Interest calculated under Rule of 78s method of accounting.* An interest recipient permitted by Revenue Procedure 83-40, 1983-1 C.B. 774, (or other revenue procedure) to use the Rule of 78s method of accounting to calculate interest earned on a transaction may report as interest received on a mortgage interest earned on the transaction as calculated under the Rule of 78s method of accounting only if the interest recipient satisfies the notice requirement of §1.6050H-2(c).

(f) [Reserved].

(g) *Effective date.* This section is effective for mortgage interest received after December 31, 1987. Section 1.6050H-1T contains rules for reporting mortgage interest received after December 31, 1984, and before January 1, 1988.

§1.6050H-2 Time, form, and manner of reporting interest received on qualified mortgage.

(a) *Requirement to file return*—(1) *Form of return.* An interest recipient must file a return required by §1.6050H-1(a) on Form 1098 (with Form 1096 as the transmittal form). An interest recipient may use forms containing provisions substantially similar to those in Forms 1098 and 1096 if it complies with applicable revenue procedures relating to substitute Forms 1098 and 1096. An interest recipient must file a separate return for each qualified mortgage for which it receives $600 or more of interest for a calendar year.

(2) *Information included on return.* An interest recipient must include on Form 1098:

(i) The name, address, and taxpayer identification number (TIN) (as defined in section 7701(a)(41)) of the payor of record;

(ii) The name, address, and TIN of the interest recipient;

(iii) The amount of interest required to be reported with respect to the qualified mortgage for the calendar year; and

(iv) Any other information required by Form 1098 or its instructions.

Section 1.6050H-1(e) contains rules to determine the amount of interest received on a mortgage for a calendar year.

(3) *Time and place for filing return.* An interest recipient must file a return required by paragraph (a) of this section on or before February 28 of the year following the calendar year for which it receives the mortgage interest. An interest recipient must file the return with the same Internal Revenue Service Center where it files its other returns.

(4) *Use of magnetic media.* An interest recipient must file the return required by paragraph (a) of this section on magnetic media only if required by section 6011(e) and the regulations thereunder. An interest recipient not required by section 6011(e) to file returns on magnetic media may request permission to do so. Section 301.6011-2 contains rules relating to the use of magnetic media. A failure to file on magnetic media when required constitutes a failure to file an information return under section 6721.

(b) *Requirement to furnish statement*—(1) *In general.* An interest recipient that must file a return under paragraph (a) of this section must furnish a statement to the payor of record.

(2) *Information included on statement.* An interest recipient must include on the statement that it must furnish to a payor of record:

(i) The information required under paragraph (a)(2) of this section;

(ii) A legend identifying the statement as important tax information which is being furnished to the Internal Revenue Service, and notifying the payor of record that if the payor of record is required to file a return, a negligence penalty or other sanction will be imposed on the payor of record if the IRS determines that an underpayment of tax results because the payor of record overstated a deduction for this mortgage interest on the payor of record's return; and

(iii) A legend stating that the payor of record may be unable to deduct the full amount of mortgage interest reported on the statement; that limitations based on the cost and value of the property securing the mortgage may apply; and that the payor of record may only deduct mortgage interest to the extent it was incurred, actually paid by the payor of record, and not reimbursed by another person.

(3) *Statement furnished pursuant to Federal mortgage program.* An interest recipient that furnishes a statement to a payor of record under a Federal mortgage program will satisfy the requirement of paragraph (b)(1) of this section if the statement contains all the information and legends required by paragraph (b)(2) of this section and is furnished by the time and at the place required by paragraph (b)(6) of this section.

(4) *Copy of Form 1098 to payor of record.* An interest recipient will satisfy the requirement of paragraph (b)(1) of this section by furnishing to a payor of record a copy of Form 1098 (or a substitute statement that complies with applicable revenue procedures) containing all the information filed with the Internal Revenue Service and all the legends required by paragraph (b)(2) of this section by the time and at the place required by paragraph (b)(6) of this section.

(5) *Furnishing statement with other information reports.* An interest recipient may transmit the statement required by paragraph (b)(1) of this section to the payor of record with other information, including other information returns, as permitted by applicable revenue procedures.

(6) *Time and place for furnishing statement.* An interest recipient must furnish a statement required by paragraph (b)(1) of this section to a payor of record on or before January 31 of the year following the calendar year for which it receives the qualified mortgage interest. The interest recipient furnishes the statement to the payor of record if it mails the statement to the payor of record's last known address.

(c) *Notice requirement for use of Rule of 78s method of accounting*—(1) *In general.* An interest recipient seeking to report interest received on a mortgage under the Rule of 78s method of accounting as permitted under §1.6050H–1 (e)(4) must notify the payor of record that the Rule of 78s method of accounting was used to calculate interest received on the mortgage and that the payor of record may not deduct as interest the amount calculated under the Rule of 78s method of accounting unless the payor of record properly uses that method to determine interest deductions. The notice must state that the payor of record may use the Rule of 78s method of accounting to determine interest paid for Federal income tax purposes only for a self-amortizing consumer loan requiring level payments at regular intervals (at least annually) over no longer than a five-year period, with no balloon payment at the end of the loan term, and only when the loan agreement provides for use of the Rule of 78s method of accounting to determine interest earned. See Rev. Proc. 83-40, 1983-1 C.B. 774; Rev. Rul. 83-84, 1983-1 C.B. 97.

(2) *Time and manner.* An interest recipient must provide notice required by paragraph (c)(1) of this section to a payor of record on or with the statement required by paragraph (b) of this section. An interest recipient may provide notice on a separate paper or on the statement required by paragraph (b) of this section.

(d) *Reporting by related parties*—(1) *In general.* An interest recipient that receives or collects interest on a mortgage for a qualified person may designate that qualified person to satisfy the reporting requirements of paragraphs (a), (b), and (c) of this section. If a designated qualified person reports as permitted under this paragraph (d), it will satisfy the requirement of paragraph (a)(2)(ii) of this section by including on Form 1098 (and Form 1096) the name, address, and TIN of either the interest recipient or the designated qualified person.

(2) *Qualified person.* A qualified person is a trade or business with respect to which the interest recipient is under common control within the meaning of §11.414(c)–2.

(3) *Designation agreement.* An interest recipient that designates a qualified person to satisfy the reporting requirements described in paragraph (d)(1) of this section must so designate in a written designation agreement. The designation agreement must identify the mortgages and calendar years for which the designated qualified person must report. Both the interest recipient and the designated qualified person must sign and retain a copy of the designation agreement, but neither must file the designation agreement with the Internal Revenue Service.

(4) *Penalties.* A designated qualified person is subject to any applicable penalties (e.g., the section 6723 penalty for failing to include correct information) as if it were an interest recipient. An interest recipient is not relieved from joint and several liability for applicable penalties by designating a qualified person under the provisions of paragraph (d)(3) of this section. Paragraph (e) of this section describes applicable penalties.

(e) *Penalty provisions*—(1) *Failure to file return or to furnish statement.* The section 6721 penalty applies to an interest recipient that fails to file a return required by paragraph (a) of this section with respect to a payor of record. The section 6722 penalty applies to an interest recipient that fails to furnish a statement required by paragraph (b) of this section to a payor of record.

(2) *Failure to furnish TIN.* The section 6676 penalty may apply to an interest recipient that fails to furnish the TIN of a payor of record on a return required by paragraph (a) of this section. The section 6676 penalty may apply to an interest recipient that fails to request and to obtain the TIN of a payor of record under paragraph (f) of this section.

(3) *Failure to include correct information.* The section 6723 penalty may apply to an interest recipient that fails to include correct information on a return required by paragraph (a) of this section or on a statement required by paragraph (b) of this section to be furnished to a payor of record.

(f) *Requirement to request and to obtain TIN*—(1) *In general.* For obligations incurred after December 31, 1987, an interest recipient must make all reasonable efforts to obtain the TIN of a payor of record when the payor of record incurs the obligation. For example, an interest recipient may require a borrower to furnish a TIN during the mortgage approval or application process. If an interest recipient does not maintain the TIN of a payor of record on a mortgage, whenever incurred, it must request the TIN at least annually and must process responses properly and promptly.

(2) *Manner of requesting TIN.* An interest recipient need not separately mail a request for a TIN. An interest recipient may include a request in its regular mailing of payment coupon booklets or annual statements. If an interest recipient makes no mailing to a payor of record during the year in which the payor of record incurs the obligations, it must request the TIN in a separate mailing. No particular form is required to request a TIN. Nevertheless, an interest recipient must make the request on a separate paper and must clearly notify a payor of record that the Internal Revenue Service requires the payor of record to furnish a TIN in order to verify any mortgage interest deduction. An interest recipient must notify a payor of record that failure to furnish a TIN subjects the payor of record to a $50 penalty imposed by the Internal Revenue Service. A request for a TIN made on Form W-9 satisfies the requirement of this paragraph (f)(2).

(g) *Effective date.* This section is effective for mortgage interest received after December 31, 1987. Section 1.6050H-1T contains rules for reporting mortgage interest received after December 31, 1984, and before January 1, 1988.

REPORTING AND
RECORDKEEPING
REQUIREMENTS
(26 CFR Part 602)

Par. 5. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.***

Par. 6. Section 602.101(c) is amended by inserting in the appropriate place in the table "§1.6050H-1 . . . 1545-0901" and "§1.6050H-1 . . . 1545-0901."

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved March 24, 1988.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on April 11, 1988, 8:45 a.m., and published in the issue of the Federal Register for April 12, 1988, 53 F.R. 12000)

---

26 CFR 1.6050H-1T: Questions and answers concerning information returns relating to mortgage interest received in a trade or business from individuals.

Printing of substitutes for Forms 1096, 1098, 1099, 5498 and W-2G. See Rev. Proc. 88-28, page 804.

Section 6050J.—Returns Relating to Foreclosures and Abandonments of Security

26 CFR 1.6050J-1T: Questions and answers concerning information returns relating to foreclosures and abandonments of security.

Printing of substitutes for Forms 1096, 1098, 1099, 5498 and W-2G. See Rev. Proc. 88-28, page 804.

Section 6050L.—Returns Relating to Certain Dispositions of Donated Property

26 CFR 1.6050L-1: Information return by donees relating to certain dispositions of donated property.

Whether deductions in excess of $5,000 claimed for certain charitable contributions of property and to information returns by donees who make certain dispositions of donated property must be filed. See T.D. 8199, page 99.

Section 6050N.—Returns Regarding the Payment of Royalties

Printing of substitutes for Forms 1096, 1098, 1099, 5498 and W-2G. See Rev. Proc. 88-28, page 804.

Section 6081.—Extension of Time for Filing Returns

26 CFR 1.6081-2T: Automatic extension of time to file partnership return of income (temporary).

T.D. 8190

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER A, SUBCHAPTER H, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Automatic Extension of Time to File Partnership Return of Income and Trust Income Tax Return

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the automatic extension of time to file partnership returns of income and trust income tax returns. The temporary regulations affect persons filing partnership and trust returns and provide those persons with the guidance necessary to comply with the law. The text of the temporary regulations also serves as the text of the proposed regulations for the notice of proposed rulemaking on this subject *** [page 934, this Bulletin].

EFFECTIVE DATE: The regulations apply to partnership and trust returns required to be filed for taxable years beginning after December 31, 1986.

SUPPLEMENTARY
INFORMATION:

BACKGROUND

Section 6081(a) of the Internal Revenue Code of 1986 authorizes the Secretary to grant a reasonable extension of time to file returns. Currently, if a partnership or trust needs an extension of time to file a return, the partnership or trust must request an extension on Form 2758 and include a detailed explanation of the reasons an extension is necessary. The Internal Revenue Service's administrative practice has been to routinely approve these requests. In order to formalize current administrative practice, these temporary regulations provide rules for obtaining an automatic extension of time to file partnership returns of income and trust income tax returns.

In the case of a partnership, an automatic three-month extension may be obtained for a taxable year beginning after December 31, 1986, and before January 1, 1988, by filing a properly prepared Form 2758 with the words "AUTOMATIC EXTENSION UNDER §1.6081-2T" typed or legibly printed on line 4 of Form 2758. For taxable years beginning after December 31, 1987, Form 8736 must be used. Form 2758 or 8736 must be filed by the due date for filing the partnership return with the Internal Revenue Service Center where the partnership return is required to be filed.

In the case of a trust, an automatic three-month extension may be obtained for a taxable year beginning after December 31, 1986, and before January 1, 1988, by filing a properly prepared Form 2758 with the words "AUTOMATIC EXTENSION UNDER §1.6081-3T" typed or legibly printed on line 4 of Form 2758. For taxable years beginning after December 31, 1987, Form 8736 must be used. Form 2758 or 8736 must be filed by the due date for filing the trust return with the Internal Revenue Service Center where the trust return is required to be filed and must be accompanied by remittance of the full amount of the estimated unpaid tax liability.

An automatic extension of time to file a partnership or trust return does not extend the time for filing a partner's or beneficiary's income tax return. Because the time for filing the income tax return of partners and beneficiaries is not extended when a partnership or trust obtains an extension of time to file its return, the Internal Revenue Service will monitor the new automatic extension procedure to ascertain whether the lack of notice to partners and beneficiaries that the extension has been requested is engendering substantial filing difficulties for the partners and beneficiaries. If it becomes apparent that most partnerships and trusts are routinely requesting an automatic extension and that these requests are unduly delaying the filing of partner and beneficiary returns or causing substantial inconvenience to partners and beneficiaries, the Internal Revenue Service will reconsider the appropriateness of allowing automatic extensions of time to file partnership and trust returns.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291. Therefore, a regulatory impact analysis is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

PAPERWORK REDUCTION ACT

The collection of information requirements contained in these regulations have been submitted to the Office of Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduction Act of 1980. These requirements have been approved by OMB

* * * * *

Adoption of amendments to the regulations.

For the reasons set forth in the preamble, Title 26, Chapter 1, Subchapter A, Part 1, and Subchapter H, Part 602, of the Code of Federal Regulations is amended as set forth below:

Paragraph 1. The authority for Part 1 continues to read as follows:

Authority: 26 U.S.C. 7805. * * *

Par. 2. The following new §§1.6081-2T and 1.6081-3T shall be added in the appropriate place.

§1.6081-2T Automatic extension of time to file partnership return of income (temporary).

(a) *In general.* A partnership required to file a return of income on Form 1065 for any taxable year beginning after December 31, 1986, shall be allowed an automatic extension of time to file such return to the fifteenth day of the third month following the month in which falls the date prescribed for filing such return if and only if an application under this section is filed in accordance with paragraph (b) of this section. In the case of a partnership described in §1.6081-2(a)(1), the automatic extension allowed under this section shall run concurrently with an extension of time to file granted pursuant to §1.6081-2(a).

(b) *Requirements.* In order to satisfy this paragraph (b), an application for an automatic extension under this section must satisfy the following requirements:

(1) The application must be prepared (i) on Form 2758, "Application for Extension of Time to File U.S. Partnership, Fiduciary, and Certain Other Returns," for a taxable year beginning after December 31, 1986, and before January 1, 1988, by typing or legibly printing on line 4 "AUTOMATIC EXTENSION UNDER §1.6081-2T," and (ii) on Form 8736 for taxable years beginning after December 31, 1987;

(2) The application must be signed by a general partner authorized to file the partnership's Form 1065 or other person authorized by such general partner to file the application, but only if such other person is (i) an attorney who is a member in good standing of the bar of the highest court of a state, possession, territory, commonwealth, or the District of Columbia, (ii) a certified public accountant duly qualified to practice in a state, possession, territory, commonwealth, or the District of Columbia, or (iii) a person currently enrolled to practice before the Treasury Department; and

(3) The application must be filed on or before the later of (i) the date prescribed for filing the partnership return with the Internal Revenue Service Center where the partnership return is required to be filed (without regard to any extensions of the time for filing such return), and (ii) the expiration of any extension of time to file granted such partnership pursuant to §1.6081-2(a).

(c) *Payment of section 7519 amount.* An automatic extension of time for filing a partnership return under this section does not extend the time for payment of any amount due under section 7519, relating to required payments for entities electing not to have a required taxable year.

(d) *Section 444 election.* An automatic extension of time for filing a partnership return shall run concurrently with any extension of time for filing a return allowed because of section 444, relating to the election of a taxable year other than a required taxable year.

(e) *Effect of extension on partner.* An automatic extension of time for filing a partnership return under this section shall not operate to extend the time for filing a partner's income tax return or the time for the payment of any tax due on such return.

(f) *Termination of automatic extension.* The district director, including the Director of Foreign Programs, or the director of a service center may, in his or her discretion, terminate at any time an automatic extension by mailing to the partnership, or to the person who requested such extension for the partnership, a notice of termination. The notice shall be mailed at least 10 days prior to the termination date designated in such notice. The notice of termination shall be sufficient for all purposes when mailed to the partnership at its address shown on Form 1065 or to the person who requested such extension for the partnership at his or her last known address or last known place of business, even if such person is deceased or is under a legal disability.

(g) *Coordination with §1.6081-1.* Except in undue hardship cases, no extension of time for filing a partnership return of income shall be granted under §1.6081-1 until an automatic extension has been granted pursuant to the provisions of this section.

(h) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

§1.6081-3T Automatic extension of time to file trust income tax return (temporary).

(a) *In general.* A trust required to file a return of income tax on Form 1041 or on Form 1041S for any taxable year beginning after December 31, 1986, shall be allowed an automatic extension of time to file such return to the fifteenth day of the third month following the month in which falls the date prescribed for filing such return if and only if an application under this section is filed in accordance with paragraph (b) of this section.

(b) *Requirements.* In order to satisfy this paragraph (b), an application for an automatic extension under this section must satisfy the following requirements:

(1) The application must be prepared (i) on Form 2758, "Application for Extension of Time to File U.S. Partnership, Fiduciary, and Certain Other Returns," for a taxable year beginning after December 31, 1986, and before January 1, 1988, by typing or legibly printing on line 4 "AUTOMATIC EXTENSION UNDER §1.6081-3T," and (ii) on Form 8736 for taxable years beginning after December 31, 1987;

(2) The application must be signed by a fiduciary authorized to file the trust's Form 1041 or Form 1041S or other person duly authorized to file the trust's Form 1041 or Form 1041S. Such other person must be (i) an attorney who is a member in good standing of the bar of the highest court of a state, possession, territory, commonwealth, or the District of Columbia, (ii) a certified public accountant duly qualified to practice in a state, possession, territory, commonwealth, or the District of Columbia, (iii), a person currently enrolled to practice before the Treasury Department, or (iv) a duly authorized agent holding a power of attorney with respect to the filing of a trust return of income tax;

(3) The application must be filed on or before the date prescribed for filing the trust return of income tax with the Internal Revenue Service Center where the trust return of income tax is required to be filed; and

(4) The application for extension must show the full amount properly estimated as tax for the trust for the taxable year and must be accompanied by the full remittance of the amount properly estimated as tax which is unpaid as of the date prescribed for filing the return.

(c) *Effect of extension on beneficiary.* An automatic extension of time to file a trust return of income under this section shall not operate to extend the time for filing the income tax return of a beneficiary of the trust or the time for the payment of any tax due on such return.

(d) *Termination of automatic extension.* The district director, including the Director of Foreign Programs, or the director of a service center may, in his or her discretion, terminate at any time an automatic extension by mailing to the fiduciary authorized to file the trust's Form 1041 or 1041S, or to the person who requested such extension for the trust, a notice of termination. The notice shall be mailed at last 10 days prior to the termination date designated in such notice. The notice of termination shall be sufficient for all purposes when mailed to the fiduciary authorized to file the trust's Form 1041 or 1041S at his or her address shown on Form 1041 or 1041S or to the person who requested such extension for the trust at his or her last known address or last known place of business, even if such person is deceased or is under a legal disability.

(e) *Coordination with §1.6081-1.* Except in undue hardship cases, no extension of time for filing a trust return of income tax shall be granted under §1.6081-1 until an automatic extension has been granted pursuant to the provisions of this section.

(f) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

Par. 3. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. Section 602.101(c) is amended by inserting in the appropriate places in the table "§1.6081-2T—1.6081-3T . . . 1545-0000.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved March 24, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 31, 1988, 2:08 p.m., and published in the issue of the Federal Register for April 5, 1988, 53 F.R. 11066)

Subchapter B.—Miscellaneous Provisions

Section 6110.—Public Inspection of Written Determinations

26 CFR 301.6110-1: Public inspection of written determinations and background file documents.

Procedures are prescribed for the public to request the background file documents relating to a ruling letter or a technical advice memorandum issued by the National Office. See Rev. Proc. 88-11, page 636.

Chapter 63.—Assessment
Subchapter B.—Deficiency Procedures in the Case of Income, Estate, Gift, and Certain Excise Taxes

Section 6212.—Notice of Deficiency

26 CFR 301.6212-1: Notice of deficiency.

Circumstances are described under which the Service and a taxpayer may enter into an agreement to rescind a notice of deficiency. The procedure to be followed in rescinding a notice is described. See Rev. Proc. 88-17, page 692.

Subchapter C.—Tax Treatment of Partnership Items

Section 6231.—Definitions and Special Rules

26 CFR 301.6231(a)(7)-1T: Designation of tax matters partner.

Procedures are described under which the Internal Revenue Service will select a tax matters partner (TMP) for a partnership pursuant to section 6231(a)(7) of the Code. Criteria that the Service will consider in selecting the TMP is also described. See Rev. Proc. 88-16, page 691.

Chapter 64.—Collection
Subchapter A.—General Provisions

Section 6302.—Mode or Time of Collection

26 CFR 1.6302-3: Use of Government depositaries in connection with estimated taxes of certain trusts.

T.D. 8192

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, SUBCHAPTER H, PART 1—INCOME TAX REGULATIONS; PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Deposits of Estimated Tax Payments of Certain Trusts

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides a final regulatory amendment that requires certain banks and financial institutions to deposit estimated income tax payments with respect to taxable trusts for which they act as fiduciaries through the Federal Tax Deposit (FTD) system instead of forwarding them to an Internal Revenue Service Center. The amendment would affect certain financial institutions which are authorized depositaries for Federal taxes and which act as fiduciaries for at least 200 taxable trusts.

DATE: This amendment is applicable and effective for estimated tax payments required to be made with respect to certain trusts on and after September 15, 1988.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On November 18, 1987, the FEDERAL REGISTER published (52 FR 44139) a notice of proposed rulemaking regarding a proposed amendment to the Income Tax Regulations under section 6302(c) of the Internal Revenue Code of 1986 relating to deposits of certain quarterly estimated income tax payments required to be made by estates and trusts under section 6654(1) of the Internal Revenue Code of 1986. This document contains final regulations regarding deposits under section 6302(c) of the Internal Revenue Code of 1986 of the above-described payments required to be made by certain trusts, effective for such payments required to be made on or after September 15, 1988. The regulations are issued under the authority of sections 6302(c) and 7805 of the Internal Revenue Code of 1986.

Several public comments were received in response to the notice of proposed rulemaking, but no hearing was requested with respect to the proposed amendment, and none was held. The public comments discussed several problems that the proposed amendment could cause. After consideration of these comments, it was decided to promulgate the proposed amendment with several modifications to resolve those problems. These revisions are discussed in the public comments section of this regulatory preamble.

EXPLANATION OF PROVISIONS

The final regulatory amendment requires certain banks and financial institutions to deposit through the Federal Tax Deposit (FTD) system the quarterly estimated income tax payments relating to certain taxable trusts for which such institutions act as fiduciaries, instead of delivering the payments to an Internal Revenue Service Center as is presently required.

The requirement that quarterly estimated income tax payments to be made for certain trusts and estates was enacted in section 1404(a) of the Tax Reform Act of 1986. The Service had required all estimated tax payments for the 1987 taxable year with respect to trusts and estates to be delivered to an Internal Revenue Service Center along with a Form 1041-ES estimated tax voucher. The Service has experienced administrative difficulties in processing a single payment from fiduciaries in payment of estimated tax with respect to a large number of trusts administered by such fiduciaries. The amendment helps to resolve these difficulties by requiring certain financial institutions to pay estimated tax with respect to trusts for which they act as fiduciaries through the FTD system and to make magnetic tape reports of such payments in accordance with Revenue Procedure 87-64 (1987-2 C.B. 828). The institutions subject to this requirement are those that have Treasury Tax & Loan (TT&L) accounts for deposited Federal taxes ("TT&L fiduciaries") and that administer at least 200 trusts required to make estimated tax payments during the current calendar year.

Other fiduciaries that do not have TT&L accounts and TT&L fiduciaries that administer fewer than 200 trusts and that wish to make a single estimated tax payment with respect to a large number of trusts (*i.e.*, at least 50) for which they act as fiduciaries will be permitted to elect to make such payments through the FTD system in accordance with the procedures established in Revenue Procedure 87-64.

PUBLIC COMMENTS

Most of the commentators requested that the proposed taxable-years-beginning-on January 1, 1988, effective date for implementing the FTD system with respect to trusts' estimated tax payments be postponed for up to a year to provide fiduciaries time both to adjust to the new payment system and to place all trusts on a calendar year basis as required by the Tax Reform Act of 1986. After consideration of these comments, the Service determined that the lead time from the publication of Revenue Procedure 87-64 in December 1987 until September 15, 1988, would be necessary and sufficient to implement the new estimated tax payment requirement. Therefore, the Treasury decision delays the effective date and requires certain trusts to make estimated tax payments through the FTD system beginning with payments required to be made on and after September 15, 1988.

A commentator contended that requiring every TT&L fiduciary with at least 50 taxable trusts to make estimated tax payments through the FTD system and to report them on magnetic tape would impose an undue burden on a number of small financial institutions that lack in-house magnetic tape capability. After considering this comment, the Service decided to reduce the burdens for small fiduciaries by revising this requirement so that only TT&L fiduciaries that have at least 200 trusts are required to make quarterly estimated tax payments under section 6654(1). However, it should be noted that Revenue Procedure 87-64 provides a procedure whereby fiduciaries with at least 50 taxable trusts and those without a TT&L account may apply for authorization to make estimated tax payments through the FTD system and to report them on a single magnetic tape. Thus, these fiduciaries may elect to make and report such payments in accordance with Revenue Procedure 87-64.

Two commentators objected that requiring fiduciaries to submit a preprinted individual voucher for each trust would be unduly burdensome. After consideration of both the burden of fiduciaries and the Service's requirements in order to process payments accurately, it was determined that Form 1041-ES vouchers would continue to be required in all circumstances in which a fiduciary does not use magnetic tape reporting. Fiduciaries of more than 50 taxable trusts that find use of Form 1041-ES vouchers unduly burdensome may elect to report estimated tax payments on magnetic tape in accordance with the procedures in Revenue Procudure 87-64.

Two commentators contended that requiring fiduciaries to make quarterly estimated tax payments through the FTD system for estates opened for more than 2 years would be unduly burdensome. They explained that estates comprise only a small portion of fiduciary accounts administered by banks and that estates, unlike taxable trusts, have a variety of fiscal years. Therefore, they contended, if this requirement was retained, the Service Centers would, in off-quarter months, receive a large number of magnetic tapes each reporting only a few estimated tax payments of such estates. After considering these comments, the Service decided to exclude estates from the Treasury decision's requirement to make certain estimated tax payments through the FTD system. Thus, all fiduciaries will continue to make and report estimated tax payments of taxable estates on the Form 1041-ES vouchers.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required. It has been certified that this rule will not have a significant impact on a substantial number of small entities because the regulations would be applicable only to financial institutions which administer a large number of trusts actually required to make estimated tax payments. A regulatory flexibility analysis, therefore, is not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6).

PAPERWORK REDUCTION ACT

The collection of information requirements contained in this regulation have been submitted to the Office of Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduction Act of 1980. The requirements have been approved by OMB under control number 1545-0971.

* * * * *

Adoption of amendments to the regulations

Accordingly, 26 CFR Parts 1 and 602 are amended as follows:

INCOME TAX REGULATIONS
(26 CFR Part 1)

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. *** Section 1.6302-3 also issued under 26 U.S.C. 6302(c).***

Par. 2. A new §1.6302-3 is added immediately following §1.6302-2 to read as follows:

§1.6302-3 Use of Government depositaries in connection with estimated taxes of certain trusts.

(a) *Requirement*. A bank or other financial institution described in paragraph (b) of this section shall deposit in its Treasury Tax & Loan account described in 31 CFR 203 or with a Federal Reserve bank all payments of estimated tax required to be paid on or after September 15, 1988, under section 6654(1) with respect to trusts for which such institution acts as a fiduciary on or before the date otherwise prescribed for paying such tax.

(b) *Banks and financial institutions subject to this requirement*. The requirement of paragraph (1) of this section applies to banks and other financial institutions described in sections 581 and 591 that have been designated as authorized Federal tax depositaries described in section 6302(c) and that act as fiduciaries for at least 200 trusts to which section 6654(1) applies that during the calendar year are required to make installment payments of estimated tax with respect to such trusts. For purposes of this section, a fiduciary is the person responsible for filing the tax returns and paying the taxes with respect to a trust.

(c) *Cross references*. For provisions relating to the procedures for depositing the estimated tax payments described in paragraph (a) of this section and for reporting such deposits on magnetic tape, see Revenue Procedure 87-64 or its successor. For provisions relating to the penalty for failure to make a deposit within the prescribed time, see §301.6656-1 of this chapter (Regulations on Procedure and Administration).

OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT
(26 CFR Part 602)

Par. 3. The authority citation for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. Section 602.101(c) is amended by inserting in the appropriate place in the table "§1.6302- 3 . . . 1545-0971".

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved April 4, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 8, 1988, 2:51 p.m., and published in the issue of the Federal Register for April 12, 1988, 53 F.R. 12006)

Subchapter B.—Receipt of Payment

Section 6323.—Validity and Priority Against Certain Persons

26 CFR 301.6323(f)-1T: Place for filing notice; form.

T.D. 8174

TITLE 26—INTERNAL REVENUE.—CHAPTER 64, SUBCHAPTER C, PART 301—PROCEDURE AND ADMINISTRATION

Electronic Filing of Notice of Federal Tax Lien

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to a notice of Federal tax lien filed by the use of an electronic or magnetic medium. These temporary regulations clarify existing regulations under section 6323(f) of the Code.

DATES: The temporary regulations are effective for a notice of Federal tax lien filed on or after February 23, 1988.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document amends the Administrative Regulations (26 CFR Part 301) under section 6323 of the Internal Revenue Code of 1986 (Code). These regulations clarify that the term "Form 668" includes a notice of Federal tax lien filed by the use of an electronic or magnetic medium where the law of the state in which a notice of Federal tax lien is filed permits such method of filing.

IN GENERAL

Section 6321 of Code imposes a lien in favor of the United States whenever a person liable for any tax neglects or refuses to pay the tax after demand. For such lien to be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor, a notice of the lien must be filed which meets the requirements of section 6323(f). Section 6323(f)(3) provides that the form and content of the notice referred to in section 6323(a) shall be prescribed by the Secretary, and that such notice is valid notwithstanding any other provision of law regarding the form or content of a notice of lien.

NOTICE OF LIEN MAY BE FILED BY THE USE OF AN ELECTRONIC OR MAGNETIC MEDIUM

Section 301.6323(f)-1(c) of the regulations provides that notice of a Federal tax lien "shall be filed on Form 668, 'Notice of Federal Tax Lien under Internal Revenue Laws'." These temporary regulations clarify that the term "Form 668" includes both a Form 668 printed on paper and a Form 668 filed by the use of an electronic or magnetic medium if the law of the state in which the notice is filed permits a notice of Federal tax lien to be filed by the use of such medium. The use of a non-paper form will not affect the decision to place a notice of lien on file and will not significantly affect the timing of issuance of a notice of lien. Rather, the use of a non-paper form merely simplifies the manner of transmitting information to a state after a lien is determined to be valid and any remaining issues are resolved. Paper forms will continue to be used in states that do not permit electronic or magnetic filing.

The use of electronic or magnetic media to file a notice of tax lien will enable the Internal Revenue Service to better serve the pulblic by (a) reducing the time it takes to notify the public that a lien exists; (b) reducing the amount of paperwork necessary to file a notice; and (c) in certain cases, eliminating or reducing the cost of filing a notice of lien, which cost is generally billed to the taxpayer involved.

REFILING A NOTICE OF LIEN

Section 6323(g) of the Code and §301.6323(g)-1 of the regulations, which govern the refiling of a notice of Federal tax lien, do not require a particular form to be used in refiling a notice of Federal tax lien. Therefore, an amendment to the regulations is not necessary to allow a notice of Federal tax lien to be refiled by the use of any electronic or magnetic medium permitted by the state in which the notice is refiled.

SPECIAL ANALYSES

A general notice of proposed rulemaking is not required by 5 U.S.C. 553(b) for temporary regulations. Accordingly, the Regulatory Flexibility Act (5 U.S.C. Chapter 6) does not apply and no Regulatory Flexibility Analysis is required for this rule. The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291, and that a Regulatory Impact Analysis is therefore not required.

* * * * *

Adoption of amendments to the regulations

Accordingly 26 CFR Part 301 is amended as follows:

Paragraph 1. The authority for Part 301 is amended by adding the following citation:

Authority: 26 U.S.C. 7805 *** Section 301.6323(f)-1T(c) is also issued under 26 U.S.C. 6323(f)(3).

Par. 2. A new §301.6323(f)-1T(c) is added immediately after §301.6323 (f)-1(c) to read as follows:

§301.6323(f)-1T *Place for filing notice; form. (Temporary)*

(a) (Reserved)

(b) (Reserved)

(c) *Form*—(1) *In general.* The notice referred to in §301.6323(a)-1 shall be filed on Form 668, "Notice of Federal Tax Lien under Internal Revenue Laws". Such notice is valid notwithstanding any other provision of law regarding the form or content of a notice of lien. For example, omission from the notice of lien of a description of the property subject to the lien does not affect the validity thereof even though State law may require that the notice contain a description of the property subject to the lien.

(2) *Form 668 defined.* The term "Form 668" generally means a paper form. However, if a state in which a notice referred to in §301.6323 (a)-1 is filed permits a notice of Federal tax lien to be filed by the use of an electronic or magnetic medium, the term "Form 668" includes a Form 668 filed by the use of any electronic or magnetic medium permitted by that state. A Form 668 must identify the taxpayer, the tax liability giving rise to the lien, and the date the assessment arose regardless of the method used to file the notice of Federal tax lien.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

Approved February 9, 1988.

O. Donaldson Chapoton,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on February 22, 1988, 8:45 a.m., and published in the issue of the Federal Register for February 23, 1988, 53 F.R. 5269)

Chapter 67.—Interest
Subchapter C.—Determination of Interest Rate; Compounding of Interest

Section 6621—Determination of Rate of Interest

26 CFR 301.6621-1: Interest rate.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning April 1, 1988, will decrease to 9 percent for overpayments and 10 percent for underpayments.

Rev. Rul. 88-17

Section 6621 of the Internal Revenue Code establishes differential rates for allowance of interest on tax overpayments and assessment of intereston tax underpayments. Under section 6621(a)(1), the overpayment rate is the sum of the short-term federal rate plus 2 percentage points. Under section 6621(a)(2), the underpayment rate is the sum of the short-term federal rate plus 3 percentage points.

Section 6621(b)(1) of the Code provides that the Secretary shall determine the short-term federal rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) of the Code provides that the federal short-term rate determined under section 6621(b)(1) for any month shall apply during the first calendar quarter beginning after such month.

Section 6621(b)(2)(B) of the Code provides that in determining the addition to tax under section 6654 for failure to pay estimated tax for any taxable year the federal short-term rate that applies during the 3rd month following such taxable year shall also apply during the first 15 days of the fourth month following such taxable year.

Section 6621(b)(3) of the Code provides that the federal short-term rate for any month shall be the federal short-term rate determined during such month by the Secretary in accordance with section 1274(d), rounded to the nearest full percent (or, if a multiple of 1/2 of 1 percent, such rate shall be increased to the next highest full percent).

Rounded to the nearest full percent, the federal short-term rate determined during the month of January 1988 is 7 percent. Accordingly, an overpayment rate of 9 percent and an underpayment rate of 10 percent is established for the calendar quarter beginning April 1, 1988. The rates apply to amounts bearing interest during that calendar quarter. Pursuant to section 6621(b)(2)(B) of the Code, the 10 percent rate applicable to individual estimated tax underpayments also applies from April 15, 1988, through June 30, 1988.

Interest factors for daily compound interest for annual rates of 9 percent and 10 percent were published in Tables 39 and 40 of Rev. Proc. 83-7, 1983-1 C.B. 583, 623, 624.

Annual interest rates to be compounded daily pursuant to section 6622 of the Code that apply for prior periods are set forth in the following table:

PERIOD	RATE	DAILY RATE TABLE IN 1983-1 C.B.
	OVERPAYMENTS AND UNDERPAYMENTS	
January 1, 1983—June 30, 1983	16%	Table 22, pg. 605
July 1, 1983—December 31, 1983	11%	Table 17, pg. 600
January 1, 1984—June 30, 1984	11%	Table 41, pg. 625
July 1, 1984—December 31, 1984	11%	Table 41, pg. 625
January 1, 1985—June 30, 1985	13%	Table 19, pg. 602
July 1, 1985—December 31, 1985	11%	Table 17, pg. 600
January 1, 1986—June 30, 1986	10%	Table 16, pg. 599
July 1, 1986—December 31, 1986	9%	Table 15, pg. 598

PERIOD	RATE	DAILY RATE TABLE IN 1983-1 C.B.
	OVERPAYMENTS	
January 1, 1987—March 31, 1987	8%	Table 14, pg. 597
April 1, 1987-June 30, 1987	8%	Table 14, pg. 597
July 1, 1987—September 30, 1987	8%	Table 14, pg. 597
October 1, 1987—December 31, 1987	9%	Table 15, pg. 598
January 1, 1988—March 31, 1988	10%	Table 40, pg. 624
	UNDERPAYMENTS	
January 1, 1987—March 31, 1987	9%	Table 15, pg. 598
April 1, 1987—June 30, 1987	9%	Table 15, pg. 598
July 1, 1987—September 30, 1987	9%	Table 15, pg. 598
October 1, 1987—December 31, 1987	10%	Table 16, pg. 599
January 1, 1988—March 31, 1988	11%	Table 41, pg. 625

---

26 CFR 301.6621-1: Interest rate.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning July 1, 1988, will remain at 9 percent for overpayments and 10 percent for underpayments.

Rev. Rul. 88-50[1]

Section 6621 of the Internal Revenue Code establishes differential rates for allowance of interest on tax overpayments and assessment of interest on tax underpayments. Under section 6621(a)(1), the overpayment rate is the sum of the short-term federal rate plus 2 percentage points. Under section 6621(a)(2), the underpayment rate is the sum of the short-term federal rate plus 3 percentage points.

Section 6621(b)(1) of the Code provides that the Secretary shall determine the short-term federal rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) of the Code provides that the federal short-term rate determined under section 6621(b)(1) for any month shall apply during the first calendar quarter beginning after such month.

Section 6621(b)(3) of the Code provides that the federal short-term rate for any month shall be the federal short-term rate determined during such month by the Secretary in accordance with section 1274(d), rounded to the nearest full percent (or, if a multiple of 1/2 of 1 percent, the rate shall be increased to the next highest full percent).

Notice 88-59, page 546, this Bulletin, announced that in determining the quarterly interest rates to be used for overpayments and underpayments of tax under section 6621 of the Code, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with section 6621 which, pursuant to section 6622, is subject to daily compounding.

Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of April 1988 is 7 percent. Accordingly, an overpayment rate of 9 percent and an underpayment rate of 10 percent is established for the calendar quarter beginning July 1, 1988. The rates apply to amounts bearing interest during that calendar quarter.

Interest factors for daily compound interest for annual rates of 9 percent and 10 percent were published in Tables 39 and 40 of Rev. Proc. 83-7, 1983-1 C.B. 583, 623, 624.

Annual interest rates to be compounded daily pursuant to section 6622 of the Code that apply for prior periods are set forth in the accompanying table.

TABLE OF ANNUAL INTEREST RATES

PERIOD	RATE OVERPAYMENTS AND UNDERPAYMENTS	DAILY RATE TABLE IN 1983-1 C.B.
January 1, 1983—June 30, 1983	16%	Table 22, pg. 605
July 1, 1983—December 31, 1983	11%	Table 17, pg. 600
January 1, 1984—June 30, 1984	11%	Table 41, pg. 625
July 1, 1984—December 31, 1984	11%	Table 41, pg. 625
January 1, 1985—June 30, 1985	13%	Table 19, pg. 602
July 1, 1985—December 31, 1985	11%	Table 17, pg. 600
January 1, 1986—June 30, 1986	10%	Table 16, pg. 599
July 1, 1986—December 31, 1986	9%	Table 15, pg. 598

---

[1] Also released as News Release IR-88-93, dated June 3, 1988.

TABLE OF ANNUAL INTEREST RATES

PERIOD	RATE	DAILY RATE TABLE IN 1983-1 C.B.
	OVERPAYMENTS	
January 1, 1987—March 31, 1987	8%	Table 14, pg. 597
April 1, 1987—June 30, 1987	8%	Table 14, pg. 597
July 1, 1987—September 30, 1987	8%	Table 14, pg. 597
October 1, 1987—December 31, 1987	9%	Table 15, pg. 598
January 1, 1988—March 31, 1988	10%	Table 40, pg. 624
April 1, 1988—June 30, 1988	9%	Table 39, pg. 623
	UNDERPAYMENTS	
January 1, 1987—March 31, 1987	9%	Table 15, pg. 598
April 1, 1987—June 30, 1987	9%	Table 15, pg. 598
July 1, 1987—September 30, 1987	9%	Table 15, pg. 598
October 1, 1987—December 31, 1987	10%	Table 16, pg. 599
January 1, 1988—March 31, 1988	11%	Table 41, pg. 625
April 1, 1988—June 30, 1988	10%	Table 40, pg. 624

Chapter 76.—Judicial Proceedings
Subchapter C.—The Tax Court
Part IV.—Declaratory Judgments

Section 7478.—Declaratory Judgments Relating to Status of Certain Governmental Obligations

Rev. Proc. 84-48, 1984-1 C.B. 547, is superseded to update the procedures for the submission of requests for rulings under section 103 of the Code to which section 7478 applies. See Rev. Proc. 88-32, page 833.

Rev. Proc. 84-49, 1984-1 C.B. 548, is superseded and Rev. Proc. 84-50, 1984-1 C.B. 550,is amplified and superseded to update the procedures for the submission of requests for rulings under section 103 of the Code to which section 7478 will not apply. See Rev. Proc. 88-33, page 835.

Chapter 77.—Miscellaneous Provisions

Section 7507.—Exemption of Insolvent Banks From Tax

26 CFR 301.7507-1: Banks and trust companies covered.

Insolvent or bankrupt bank or trust company; definition; collection of tax. A savings and loan association and a building and loan association come within the term "bank and trust company" as used in section 7507 of the Code for purposes of the deferral of collection of taxes of bankrupt or insolvent bank and trust companies.

Rev. Rul. 88-18

ISSUE

Does a savings and loan association or a building and loan association come within the meaning of a "bank and trust company" as that term is used in section 7507 of the Internal Revenue Code, relating to the deferral of collection of taxes of bankrupt or insolvent banks and trust companies?

FACTS

The primary purpose of a savings and loan or building and loan association is the solicitation of savings for deposit in share accounts on which dividends are paid and from which loans are made.

LAW AND ANALYSIS

Section 7507(a) of the Code provides that in the case of a bankrupt or insolvent bank or trust company, a substantial portion of whose business consists of receiving deposits and making loans and discounts, no tax shall be assessed or collected that would diminish its assets necessary for full payment of all its depositors. Section 7507(d) provides that section 7507 shall not apply in the case of the employment taxes imposed by Chapters 21 and 23.

Section 301.7507-2(a) of the Regulations on Procedure and Administration provides that section 7507 is intended to assist depositors of a bank that has ceased to do business because of insolvency to recover their deposits, by prohibiting collection of taxes of the bank that would diminish the assets necessary for payment of its depositors and also to assist depositors of banks that are in financial difficulties but continue in business.

The purpose of the statute is only to defer the collection of taxes to the extent the tax money goes to pay depositors. The bank and its owners are not intended to gain, as the taxes remain collectible out of any other part of the earnings not paid to the depositors. *Clinton Trust Co. v. United States*, 52 F. Supp. 671, (Ct. Cl. 1943).

There are both organizational and operational similarities between the usual banking institution and a savings and loan or building and loan association, such as: (1) the receiving of money deposits from the general public and the permitting of withdrawals therefrom, (2) the payment of interest (even though it may be donominated as dividends) by the institution or association upon funds deposited with it, (3) the insuring of such deposits by an agency of the federal government, and (4) the making of loans. The Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No.

96-221, 94 Stat. 132, enlarged the authority of savings and loan associations to provide consumer services previously limited to commercial banks, such as checking accounts, consumer loans and trust services as well as home mortgage loans. See S. Rep. No. 96-368, 96th Cong., 1st Sess. 3 (1980), *reprinted in* 1980 U.S. Code Cong. & Admin. News, Vol. 2, 236, 279.

Under various provisions of the Code, savings and loan associations, building and loan associations, and banks or trust companies are accorded different tax treatment. However, for purposes of section 7507 of the Code, no substantial difference exists between deposits in a savings and loan or building and loan association and deposits in a bank or trust company. Generally, the holder of a share account in a savings and loan or building and loan association is no more an investor than is a holder of a deposit account in a bank or trust company. Therefore, depositors in savings and loan associations or building and loan associations are entitled to the protection provided by section 7507.

HOLDING

A savings and loan association and a building and loan association come within the meaning of the term "bank or trust company" as used in section 7507 of the Code.

Chapter 79.—Definitions

Section 7701.—Definitions

26 CFR 301.7701-1: Classification of organizations for tax purposes.

Classification of entity organized under foreign law. An entity organized under foreign law is classified for federal tax purposes on the basis of the characteristics set forth in section 301.7701-2 of the regulations.

Rev. Rul. 88-8

ISSUE

Whether an entity organized under foreign law is classified for federal tax purposes on the basis of the characteristics set forth in section 301.7701-2 of the Procedure and Administration Regulations.

FACTS

In 1986, twenty-five United States citizens organized *M* in Great Britain as an unlimited company by registering *M* under the Companies Act 1985 (Act), Vol. 8, *Halsbury's Statutes of England and Wales*, (4th Ed., 1985). *M* will not be conducting insurance business (and thus is not an insurance company within the meaning of section 7701(a)(3) of the Internal Revenue Code).

Chapter I, Section 1(2) of the Act provides that a company may be:

(a) a company having the liability of its members limited by the [Memorandum of Association] to the amount, if any, unpaid on the shares respectively held by them ("a company limited by shares");

(b) a company having the liability of its members limited by the [Memorandum of Association] to such amount as the members may respectively thereby undertake to contribute to the assets of the company in the event of its being wound up ("a company limited by guarantee"); or

(c) a company not having any limit on the liability of its members ("an unlimited company").

A company is registered under the Act by delivering to the Registrar of Companies for England (Registrar) the company's Memorandum of Association (Memorandum) and Articles of Association (Articles). After registration, the Registrar provides a certificate which indicates that the company is incorporated. Thus, the Act represents Great Britain's "corporation" statute. The effect of registering a company is that, from the date of incorporation stated in the Certificate of Incorporation, the subscribers of the Memorandum, together with such other persons as may from time to time become members of the company, shall be a body corporate by the name contained in the Memorandum, capable of exercising all the functions of an incorporated company, but with such liability on the part of the members to contribute to the assets of the company in the event of its being wound up as provided by the Act.

The Memorandum sets forth the company's name, location, business objective, and share capital. The Memorandum also states the degree of liability assumed by the members of the company. The Memorandum of *M* provides that there will be no limit on the liability of its members.

The Articles contain regulations for the internal management of the company and for the conduct of its business. Under the Act, there are no restrictions on transfer except as imposed by the Articles of Association. The Articles provide that a member may not substitute a person who is not a member of *M*, unless the member obtains the consent of the other members.

LAW AND ANALYSIS

Section 7701(a)(3) of the Code provides that the term "corporation" includes associations, joint-stock companies, and insurance companies.

Section 301.7701-1(b) of the regulations states that the Code prescribes certain categories or classes into which various organizations fall for purposes of taxation. These categories or classes include associations (which are taxable as corporations), partnerships, and trusts. The tests or standards that are to be applied in determining the classification of an organization are set forth in sections 301.7701-2 through 301.7701-4.

Section 301.7701-2(a)(1) of the regulations sets forth the following basic characteristics of a corporation: (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) limited liability, and (6) free transferability of interests. Whether a particular organization is to be classified as an association must be determined by taking into account the presence or absence of each of these corporate characteristics.

Section 301.7701-2(a)(2) of the regulations further provides that characteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership. Since associates and an objective to carry on business and divide the gains therefrom are generally common to corporations and partnerships, the determination of whether an organization that has such characteristics is to be treated for tax purposes as a partnership or as an association depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability. Section 301.7701-2(a)(3) provides that an unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics.

Rev. Rul. 73-254, 1973-1 C.B. 613, holds that the classification of a foreign unincorporated business organization for federal tax purposes will be determined under section 7701 of the Code and the regulations thereunder. However, it is the local law of the foreign jurisdiction that must be applied in determining the legal relationships of the members of the organization among themselves and with the public at large, as well as the interests of the members of the organization in its assets.

An entity organized under foreign law cannot be classified for federal tax purposes solely on the basis of the label attached to the entity by the statute under which it is established, without an inquiry into the legal relationships of the members of the entity as established under applicable local law. Accordingly, the applicable foreign statute and the entity's organization agreements must be examined to determined whether the entity is classified as a corporation for federal tax purposes. In order to ensure uniformity and certainty regarding the classification of an entity organized under foreign law for federal tax purposes, the standards set forth in section 301.7701-2 of the regulations must be applied. All foreign entities are considered to be "unincorporated organizations" for purposes of section 301.7701-2(a)(3) of the regulations. Consequently, no foreign organization or entity is classified as an association unless such organization or entity has more corporate than non-corporate characteristics.

In the present situation, *M* has associates and an objective to carry on business and divide the gains therefrom and, therefore, is properly classified as either an association or a partnership. *M* will be classified as a partnership for federal tax purposes unless the organization has a preponderance of the remaining corporate characteristics of continuity of life, centralization of management, limited liability, and free transferability of interests.

Section 301.7701-2(d)(1) of the regulations provides that an organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization. Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim.

As permitted under the Act, the Memorandum provides that the members' liability to contribute to the payment of *M*'s debts and liabilities is unlimited. Consequently, *M* lacks the corporate characteristic of limited liability.

Under section 301.7701-2(e)(1) of the regulations, an organization has the corporate characteristic of free transferability of interests if each of the members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. In order for this power of substitution to exist in the corporate sense, the member must be able, without the consent of the other members, to confer upon the substitute all the attributes of the member's interest in the organization. The characteristic of free transferability does not exist if each member can, without the consent of the other members, assign only the right to share in the profits but cannot assign the rights to participate in the management of the organization.

Under the Articles, no member may transfer any interest in *M* without the unanimous prior written consent of the other members. Consequently, *M* lacks the corporate characteristic of free transferability of interests.

HOLDING

An entity organized under foreign law is classified for federal tax purposes on the basis of the characteristics set forth in section 301.7701-2 of the regulations. *M* has associates and an objective to carry on business and divide the gains therefrom but lacks the corporate characteristics of limited liability and free transferability of interests. Therefore, *M* is classified as a partnership for federal tax purposes.

---

26 CFR 301.7701-2: Associations.

Limited partnerships. The state of Texas is added to the list of states that have enacted legislation that corresponds to the Uniform Limited Partnership Act for purposes of section 301.7701-2 of the regulations. Rev. Rul. 84-80 amplified.

Rev. Rul. 88-23

In Rev. Rul. 84-80, 1984-1 C.B. 275, Rev. Rul. 84-180, 1984-2, C.B. 314, Rev. Rul. 85-178, 1985-2 C.B. 338, Rev. Rul. 86-30, 1986-1 C.B. 370, and Rev. Rul. 86-112, 1986-2 C.B. 214, the Internal Revenue Service listed several states that revised their limited partnership statutes following the promulgation of the Revised Uniform Limited Partnership Act. The Service determined that the legislation enacted by those states corresponds to the Uniform Limited Partnership Act (ULPA) for purposes of section 301.7701-2 of the Procedure and Administration Regulations.

The Service has determined that the following additional state has enacted legislation that, as of its effective date, corresponds to the ULPA for purposes of section 301.7701-2 of the regulations:

Texas: Texas Revised Civil Statutes Annotated, art. 6132a-1, effective September 1, 1987.

EFFECT ON OTHER RULINGS

Rev. Rul. 84-80 is amplified.

---

26 CFR 301.7701-2: Associations.

Limited partnerships. The state of Florida is added to the list of states that have enacted legislation that corresponds to the Uniform Limited Partnership Act for purposes of section 301.7701-2 of the regulations. Rev. Rul. 84-80 amplified.

Rev. Rul. 88-43

In Rev. Rul. 84-80, 1984-1 C.B. 275, as amplified by Rev. Rul.

84-180, 1984-2, C.B. 314, Rev. Rul. 85-178, 1985-2 C.B. 338, Rev. Rul. 86-30, 1986-1 C.B. 370, and Rev. Rul. 86-112, 1986-2 C.B. 214, the Internal Revenue Service listed several states that revised their limited partnership statutes following the promulgation of the Revised Uniform Limited Partnership Act. The Service determined that the legislation enacted by those states corresponds to the Uniform Limited Partnership Act (ULPA) for purposes of section 301.7701-2 of the Procedure and Administration Regulations.

The Service has determined that the following additional state has enacted legislation that, as of its effective date, corresponds to the ULPA for purposes of section 301.7701-2 of the regulations:

Florida: Florida Statutes Annotated, Sections 620.101—620.186 (West Supp. 1987), effective January 1, 1987.

EFFECT ON OTHER RULINGS

Rev. Rul. 84-80 is amplified.

Subchapter 80.—General Rules
Subchapter A.—Applications of
Internal Revenue Laws

Section 7805.—Rules and Regulations

26 CFR 301.7805-1: Rules and regulations

Obsolete revenue rulings. Rev. Ruls. 75-132 and 75-142, relating to the treatment of tenancy by the entireties income in the State of Michigan, are declared obsolete.

Rev. Rul. 88-2

Periodically, the Internal Revenue Service has obsoleted revenue rulings which, although not specifically revoked or superseded, are not considered determinative with respect to future transactions because (1) the applicable statutory provisions have been changed or repealed; (2) the ruling position is specifically covered by statute, regulations, or a subsequent published position; or (3) the facts set forth no longer exist or are not sufficient to permit application of the current statute.

The revenue rulings listed below are hereby declared to be obsolete:

Rev. Rul.	No.
75-132	1975-1 C.B. 20
75-142	1975-1 C.B. 256

---

26 CFR 301.7805-1: Rules and regulations. (Also Section 851.)

Regulated investment companies; series investment companies; treatment of funds as separate corporations. New section 851(q), which provides that each fund of a series investment company is a separate corporation, renders Rev. Rul. 56-246 obsolete.

Rev. Rul. 88-14

The Internal Revenue Service periodically reviews rulings that have been published in the Internal Revenue Bulletin. The Service has reviewed Rev. Rul. 56-246, 1956-1 C.B. 316, and determined that it is obsolete.

Rev. Rul. 56-246 holds that a series investment company, organized as a corporation, constitutes one taxpayer for federal income tax purposes. Therefore, each fund maintained by such a company does not realize gain or loss on the transfer of assets from one series fund to another.

A series investment company is an open-end investment company registered under the Investment Company Act of 1940 (1940 Act) that, in accordance with the provisions of section 18(f)(2) of the 1940 Act, issues two or more classes or series of preferred or special stock, each of which is preferred over all other classes or series with respect to assets specifically allocated to that class or series. *See* 17 C.F.R. section 270.18f-2(a) (1987).

Part I of subchapter M of the Internal Revenue Code (sections 851-855) provides special tax treatment for certain companies that are subject to regulation by the Securities and Exchange Commission under the 1940 Act. Section 654 of the Tax Reform Act of 1986 amended section 851 by adding new section 851(q), which provides that each fund of a series investment company is a separate corporation for purposes of the Code. This amendment, which applies to both incorporated and unincorporated series investment companies, is effective for taxable years of series investment companies beginning after October 22, 1986. Accordingly, Rev. Rul. 56-246 is declared to be obsolete.

Subchapter C.—Provisions Affecting More
Than One Subtitle

Section 7872.—Treatment of Loans with Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1988. See Rev. Rul. 88-9, page 307.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 1988. See Rev. Rul. 88-15, page 308.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1988. See Rev. Rul. 88-22, page 309.

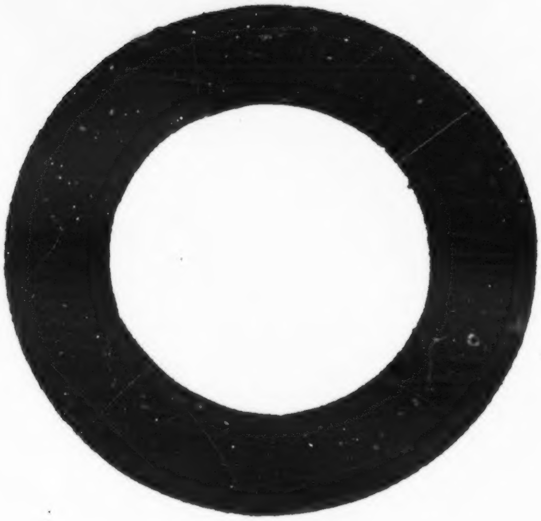
The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 1988. See Rev. Rul. 88-28, page 310.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 1988. See Rev. Rul. 88-44, page 312.

---

26 CFR 35a.9999-5: Questions and answers relating to the repeal of 30 percent withholding by section 127 of the Tax Reform Act of 1984 and the application of information reporting and backup withholding in light of such repeal.

Application of the repeal of the 30 percent witholding tax to pass-through certificates. See T.D. 8202, page 78.



Part II. Treaties and Tax Legislation

CONTENTS

Subpart A.—Tax Conventions

Tax Implementation Agreement Between United States of America and American Samoa 408

United States—The People's Republic of China Income
- Tax Convention 414
- Protocols 421 & 422
- Senate Executive Report No. 99-7 423
- Senate Executive Report No. 99-15 445
- Treasury Department Technical Explanation 447

Shipping & Aircraft Agreements

- Argentina 456
- Bahamas 458
- Belgium 459
- Bolivia 460
- Colombia 461
- Denmark 462
- El Salvador 463
- Liberia 463
- Singapore 464
- Sweden 466
- Venezuela 467

TAX IMPLEMENTATION AGREEMENT BETWEEN THE UNITED STATES OF AMERICA AND AMERICAN SAMOA

The Government of the United States of America and the American Samoa Government desiring to conclude an Agreement (hereinafter referred to as the "Agreement") for the exchange of information and mutual assistance with respect to taxes in order to prevent the evasion or avoidance of United States or American Samoa taxes have agreed as follows:

Article 1

SCOPE OF AGREEMENT

This Agreement is intended to provide for mutual assistance in tax matters, including exchanges of information, for purposes of administering the tax laws of the respective Governments and especially to prevent avoidance or evasion of the Governments' respective fiscal laws. This Agreement is the implementing agreement described in sections 1271 and 1277 of the Tax Reform Act of 1986, Pub. Law 99-514. The provisions of this Agreement are subject to provisions of the statutes, regulations, and published procedures of the Contracting Governments.

Upon entry into force, this Agreement replaces any and all prior tax coordination agreements and implementing agreements between the respective Governments.

Article 2

TAXES COVERED

1. This Agreement shall apply to the following taxes imposed by or on behalf of a Contracting Government:
   a) in the case of the United States of America, all taxes imposed by the Code, and
   b) in the case of American Samoa, all taxes imposed by the Code as it applies in American Samoa (with modifications adopted by American Samoa) and all local income taxes imposed by American Samoa as authorized by the Tax Reform Act of 1986.

2. This Agreement shall apply also to any identical or substantially similar taxes imposed after the date of signature of the Agreement in addition to or in place of the existing taxes. The competent authority of each Government shall notify the other of significant changes in laws which may affect the obligations of that Government pursuant to this Agreement.

3. This Agreement shall not apply to the extent that an action or proceeding concerning taxes covered by this Agreement is barred by the applicant Government's statute of limitations.

Article 3

DEFINITIONS

1. In this Agreement, unless otherwise defined:
   a) The term "Code" shall mean the Internal Revenue Code of 1986, as amended, and any predecessor or successor statutes.
   b) The term "competent authority" means:
      (i) in the case of the United States of America, the Secretary of the Treasury or his delegate, and
      (ii) in the case of American Samoa, the Treasurer or his delegate.
   c) The term "Contracting Government" means the United States or American Samoa as the context requires.
   d) The term "non-American Samoa source income" means income for which the source (under source rules set forth in the Code or promulgated consistently with the Code by the Internal Revenue Service) is not American Samoa.
   e) The term "person" includes an individual and a partnership, corporation, company, trust, estate, association or other legal entity.
   f) The term "tax" means any tax to which the Agreement applies.
   g) The term "taxpayer" means:
      (i) in the case of the United States, any person subject to the provisions of the Code, and
      (ii) in the case of American Samoa, any person subject to the provisions of the Code as it applies in American Samoa (including modifications adopted by American Samoa) or any local income tax laws imposed by American Samoa.
   h) For purposes of determining the geographical area in respect of which jurisdiction to compel production of information under this Agreement may be exercised, the term "United States" means the United States of America, including Puerto Rico, Guam, the Virgin Islands, the Commonwealth of the Northern Mariana Islands, and any other United States possession or territory and the territorial waters thereof, but not including American Samoa.
   i) For purposes of determining the geographical area in respect of which jurisdiction to compel production of information under this Agreement may be exercised, the term "American Samoa" means the territorial domain, lands and waters of the islands of Tutuila and Manua, the cession of which were accepted, ratified, and confirmed as of April 10, 1900 and July 16, 1904, and Swains Island and Rose Island.

2. Any term not defined in this Agreement, unless the context otherwise requires or the competent authorities agree to a common meaning pursuant to the provisions of Article 5, shall have the meaning which it has under the laws of the Contracting Governments relating to the taxes which are the subject of this Agreement.

Article 4

EXCHANGE OF INFORMATION

1. The competent authorities of the Contracting Governments shall exchange information to administer and

enforce the domestic laws of the Contracting Governments concerning taxes covered by this Agreement. Information shall be exchanged to fulfill the purposes of this Agreement without regard to whether the information relates to, or is held by, a taxpayer of a Contracting Government. Procedures for exchange of information are set forth in Appendix A, Limitations on Disclosure of Tax Information, which is incorporated by reference and made a part of this Agreement.

2. The competent authorities of the Contracting Governments shall automatically transmit information to each other for the purposes referred to in paragraph 1. The competent authorities shall determine the items of information to be exchanged pursuant to this paragraph and the procedures to be used to exchange such items of information.

a) It is intended that the United States shall routinely supply to American Samoa the following information, to the extent available and subject to the tolerances and criteria to be agreed upon by the competent authorities:

(i) copies of reports of individual, partnership, corporate, and employment audit changes (with associated reports of experts) that disclose information relevant to American Samoa;

(ii) copies of Forms 5335 (Income Subject to Withholding under Chapter 3, Internal Revenue Code, as reported on Form 1042S, and any successor or comparable forms) that disclose information relevant to American Samoa;

(iii) copies of Schedule K-1 of Form 1065 (U.S. Partnership Return of Income) and audit results, when the partnership return is examined and it appears the examination will affect returns of American Samoa taxpayers;

(iv) copies of responses to Forms 4901, 4902, and 4903, Requests for Information About Tax Forms, where such reply indicates that the taxpayer has filed a return with American Samoa;

(v) copies of Forms 1099 and all other information returns where the recipient of income is an American Samoa resident or lists an American Samoa address or the income is from American Samoa sources;

(vi) copies of the W-2 combined wage reporting tape summarizing Forms W-2AS (American Samoa Wage and Tax Statement) and Forms W-3SS (Transmittal of Wage and Tax Statements) filed with the Social Security Administration by employers in American Samoa, which tape is provided annually to the Internal Revenue Service by the Social Security Administration; and

(vii) copies of Forms 8279 (Election to be Treated as a FSC or as a Small FSC) that indicate creation or organization of any Foreign Sales Corporation (as defined in Section 922 of the Code) in American Samoa.

b) It is intended that American Samoa shall routinely supply to the United States the following information, to the extent available and subject to the tolerances and criteria to be agreed upon by the competent authorities:,

(i) copies of reports of individual, partnership, corporate, and employment audit changes (with associated reports of experts) that disclose information relevant to the United States;

(ii) information about any taxpayer who (1) is a citizen of the United States or has been a resident alien of the United States; (2) files an income tax return with American Samoa that discloses non-American Samoa source income; and (3) claims for the first time to be an American Samoa resident;

(iii) all corporate information about ownership interests in any Foreign Sales Corporation (as defined in section 922 of the Code) established in American Samoa; and

(iv) such information about corporations electing application of section 936 of the Code as may be agreed upon by the competent authorities.

c) The competent authorities of the Contracting Governments may agree to expand or limit the information to be routinely exchanged.

3. In the event American Samoa institutes a system of rebates, subsidies or reductions of tax on non-American Samoa source income, American Samoa will inform the United States, and the competent authorities will adopt and implement a program for exchange of information about such rebates, subsidies or reductions of tax and ownership interests of corporations receiving such rebates, subsidies or reductions of tax.

4. The competent authority of a Contracting Government shall spontaneously transmit to the competent authority of the other Government information which has come to the attention of the first-mentioned Government and which is likely to be relevant to, and bear significantly on, administration and enforcement of the domestic laws concerning taxes of the second-mentioned Government. The competent authorities shall determine the information to be exchanged pursuant to this paragraph and take such measures and implement such procedures as are necessary to ensure that the information is forwarded to the competent authority of the other Government.

5. The competent authority of the requested Government shall endeavor to provide information upon request by the competent authority of the applicant Government for the administration and enforcement of the domestic laws of the Contracting Gov-

ernments concerning taxes. If the information available in the tax files of the requested Government is not sufficient to enable compliance with the request, that Government shall take the necessary measures to provide the applicant Government with the information requested. If information is requested by a Contracting Government in accordance with this Article, the other Contracting Government shall obtain the information to which the request relates in the same manner (including issuance and enforcement of administrative summonses) and to the same extent as if the tax of the first-mentioned Government were the tax of that other Government and were being imposed by that other Government. Notwithstanding the foregoing, the United States may exercise its rights under section 7602 *et seq.* of the Code to obtain information in American Samoa without resorting to the procedures set forth in this Agreement. However, in the event the United States so exercises its rights within the territory of American Samoa, it shall notify the competent authority of American Samoa prior to taking action or as soon as practicable, unless the competent authorities agree to limit notification with respect to certain classes of cases.

6. The provisions of the preceding paragraphs shall not be construed so as to impose on a Contracting Government the obligation:

a) to supply particular items of information which are not obtainable under the laws of that Government or of the other Contracting Government;
b) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process;
c) to supply information, the disclosure of which would be contrary to public policy; or
d) to disclose information if such disclosure would identify a confidential informant or seriously impair a civil or criminal tax investigation.

7. Any information received by a Contracting Government shall be subject to Appendix A, Limitations on Disclosure of Tax Information.

Article 5

MUTUAL AGREEMENT PROCEDURE AND COSTS

1. The competent authorities of the Contracting Governments shall implement a program to carry out the purposes of this Agreement. In particular, the competent authorities of the Contracting Governments may amend Appendix A, by mutual agreement, as they deem necessary within the limitations of this Agreement and the Code.

2. The competent authorities of the Contracting Governments shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of this Agreement and may communicate directly for this purpose. In particular, the competent authorities may agree to the common meaning of a term and may determine when costs are extraordinary for purposes of this Article.

3. Unless the competent authorities of the Contracting Governments otherwise agree, ordinary costs incurred in providing assistance shall be borne by the requested Government and extraordinary costs incurred in providing assistance shall be borne by the applicant Government. The competent authorities of the Contracting Governments may agree not to charge each other for the costs of reproduction of information routinely exchanged.

Article 6

MUTUAL AGREEMENT PROCEDURE ON POTENTIAL DOUBLE TAXATION

1. When by reason of inconsistent positions taken by the Contracting Governments, a taxpayer is or would be subject to inconsistent tax treatment by the two jurisdictions, the competent authorities of the Contracting Governments shall endeavor to agree upon the facts and circumstances necessary to achieve consistent application of the tax laws of the respective Governments. In particular, but not by way of limitation, the competent authorities of the Contracting Governments may consult together to endeavor to agree:

a) To the same allocation of income under section 482 of the Code;
b) To the same determination of residency of a particular taxpayer; or
c) To the same determination of the source of particular items of income.

Article 7

OTHER APPLICATIONS OF AGREEMENT

1. The Contracting Governments agree that when they have knowledge that a taxpayer has changed residence from one taxing jurisdiction to the other and seeks to change methods of accounting (or to make an initial election), no such change or election shall be permitted until the competent authorities have consulted and determined that such change or election will not lead to the evasion or avoidance of taxes imposed by either of the Contracting Governments. This paragraph includes initial adoption of an accounting method or an election inconsistent with a method or election previously utilized in the other jurisdiction by the taxpayer.

2. The Contracting Governments agree that an American Samoa corporation owned or controlled directly or indirectly by a person whose beneficial ownership is undisclosed (such as through bearer shares) shall be treated as owned or controlled to that extent by a foreign person for purposes of the respective Governments' tax laws.

3. The Contracting Governments agree that for purposes of determining whether a person qualifies as a bona fide resident of American Samoa under section 931 of the Code the definition to be used shall be the definition contained in the then-applicable regulations promulgated by the United States.

4. The Contracting Governments agree that the United States may use its regulatory authority over sourcing rules under section 931(d)(2) and 7654(e) of the Code to determine that certain income is U.S.-source income.

5. Any taxpayer information disclosed to the United States shall become "taxpayer return information" as defined by section 6103(b)(3) of the Code and may be redisclosed only in accordance with provisions of the Code or an applicable treaty.

6. Subject to the restrictions and other provisions of this Agreement

and the availability of enforcement resources, the competent authorities will develop a cooperative return selection and examination program with the objective of avoiding unnecessary duplication of examination coverage.

7. Subject to the restrictions and other provisions of this Agreement, the Contracting Governments will develop a simultaneous examination program for both civil and criminal investigations.

8. To the extent permitted by law and subject to the availability of enforcement resources, the United States will assist in collecting taxes, together with interest and additions to tax, owed to American Samoa by American Samoa taxpayers present in the United States. The competent authorities will discuss appropriate procedures for facilitating such collections. Any taxes collected shall be remitted to American Samoa, less the reasonable expenses incurred in collection.

9. In addition to the exchange of tax and other information, the competent authorities will, to the extent feasible, extend to each other assistance in other tax administration matters. This may include such activities as taxpayer assistance, stocking tax forms for the public, training of personnel, preparing special statistical studies and compilations of data, lending of skilled personnel for limited periods, conducting public education programs with regard to tax law changes made by the Tax Reform Act of 1986 and subsequent legislative revisions, and development and improvement of tax administration systems and procedures, as well as such other activities as may improve tax administration.

Article 8

ENTRY INTO FORCE

For purposes of section 1271(a) of the Tax Reform Act of 1986, Pub. Law 99-514, to the extent applicable, this Agreement shall be effective as of January 1, 1987, but for all other purposes this Agreement shall enter into force on January 1, 1988.

Article 9

AMENDMENT AND TERMINATION

1. This Agreement may be modified or amended by mutual consent of the Contracting Governments.

2. This Agreement shall remain in force until terminated by one of the Contracting Governments. Either Contracting Government may terminate the Agreement at any time after the Agreement enters into force provided that at least 6 months' prior notice of termination has been given.

3. Any unauthorized use or disclosure of Federal returns or Federal return information as defined by section 6103(b)(1) and (2) of the Code furnished pursuant to this Agreement or inadequate procedures for safeguarding the confidentiality of such returns and return information, constitutes grounds for immediate termination of this Agreement and the exchange of information thereunder, subject to the rights of administrative appeal as provided by regulations prescribed by section 6103(p)(7) of the Code.

DONE by the Government of American Samoa at Utulei, in duplicate, this 10th day of December, 1987.

FOR THE AMERICAN SAMOA GOVERNMENT

A. P. Lutali,
Governor of American Samoa.

Tauanu-u F. Liaiagi,
Treasurer, American Samoa Government.

DONE by the Government of the United States of America at Washington, D.C. in duplicate, this 7th day of January, 1988.

FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA

O. Donaldson Chapoton,
Assistani Secretary (Tax Policy) Department of Treasury.

APPENDIX A

LIMITATIONS ON DISCLOSURE OF TAX INFORMATION

SECTION 1. Definitions

For purposes of this appendix, the following definitions apply:

1.1 Bureau. The term "Bureau" means the Office of the Treasurer of American Samoa and any successor agency.

1.2 IRS. The term "IRS" means the Internal Revenus Service, U.S. Department of Treasury.

1.3 Possession Audit Agency. The term "Possession Audit Agency" means the agency, body or commission which is charged under the laws of American Samoa with the responsibility of auditing Possession revenues and programs.

1.4 Possession. The term "Possession" means American Samoa.

1.5 Bureau Representative. The term "Bureau Representative" means a Bureau officer or employee designated in writing by the head of the Bureau, to the Assistant Commissioner (International) at Washington, D.C. and the Service Center Director at Philadelphia, PA, as an individual who is to inspect or receive Federal returns or Federal return information on behalf of the Bureau as provided by section 6103(d) of the Code, but only so long as the duties and employment of such officer or employee require access to Federal returns and Federal return information for purposes of Possession tax administration.

1.6 IRS Representative. The term "IRS Representative" means an officer or employee of the IRS who has been designated in writing to the head of the Bureau by the Assistant Commissioner (International) at Washington, D.C., or the Service Center Director at Philadelphia, PA, as an individual who is to inspect or receive Possession returns or Possession return information on behalf of the IRS, but only so long as the duties and employment of such officer or employee require access to Possession returns and return information for the purpose of Federal tax administration.

1.7 Federal Return. The term "Federal Return" is defined in the same manner as provided in section 6103(b)(1) of the Code.

1.8 Federal Return Information. The term "Federal Return Information" is defined in the same manner as provided in section 6103(b)(2) of the Code. However, "Federal Return Information" does not include information in the hands of the Possession which it obtained wholly from sources independent from the IRS.

9. Possession Return. The term "Possession Return" is defined in the

same manner as provided in section 6103(b)(1) of the Code as it applies in American Samoa.

1.10 Possession Return Information. The term "Possession Return Information" means a taxpayer's identity, the nature, source, or amount of his/her income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments, whether the taxpayer's Possession return was, is being, or will be examined or subject to other investigation or processing, or any other data received by, recorded by, prepared by, furnished to, or collected by the Bureau with respect to a Possession return or with respect to determination of the existence, or possible existence, of liability (or the amount thereof) of any person under the internal revenue laws, or related statutes, of the Possession, for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense.

1.11 Inspection. The term "Inspection" means any examination of a return or return information.

1.12 Disclosure. The term "Disclosure" means the making known to any person in any manner whatever a return or return information.

1.13 Possession Tax Administration. The term "Possession Tax Administration"

(a) means—
  (i) the administration, management, conduct, direction, and supervision of the execution and application of the revenue laws, or related statutes of the Possession, and
  (ii) the development and formulation of Possession tax policy relating to existing or proposed internal revenue laws, or related statutes, of the Possession; and

(b) includes assessment, collection, enforcement, litigation, publication, and statistical-gathering functions under such laws or statutes.

1.14 Code. The term "Code" means the Internal Revenue Code of 1986, as amended, and any predecessor or sucessor statutes.

SECTION 2. Disclosure of Federal Returns and Federal Return Information

2.1 Pursuant to the laws of the Possession, the Bureau is charged with the responsibility for the administration of Possession taxes imposed on income, inheritance, gifts, gross receipts from the conduct of a trade or business, real property and excise taxes on imports used in the conduct of a trade or business. Federal returns, and Federal return information (whether originals, paper copy, photocopy, microfilm, magnetic media, or any other form) received from the IRS will be used for the purpose of, and only to the extent necessary in, Possession tax administration.

2.2 This Agreement and Appendix constitute the requisite authorization pursuant to section 6103(d)(1) of the Code for the IRS to disclose to, and permit inspection by, a Bureau Representative of Federal returns and Federal return information relating to taxes imposed by chapters one, two, six, eleven, twelve, twenty-one, twenty-three, twenty-four, thirty-one, thirty-two, forty-four, forty-five, fifty-one, fifty-two, and subchapter D of chapter thirty-six of the Code.

2.3 Upon the occurrence of any change in employment, duties, or other revelant matters affecting a Bureau Representative's right to access to Federal returns and Federal return information or status as a Bureau Representative, the head of the Bureau shall promptly adivse in writing the Assistant Commissioner (International) at Washington, D.C. and the Service Center Director at Philadelphia, PA, that such individual is no longer a Bureau Representative.

2.4 A Bureau Representative to whom a Federal return or Federal return information has been disclosed may thereafter disclose such return or return information:

(a) to another employee of the Bureau for the purpose of and only to the extent necessary in the administration of the Possession tax laws for which the Bureau is responsible;

(b) to a person described in section 6103(n) of the Code or to any officer or employee of such person, solely for the purpose of Possession tax administration and in a manner consistent with applicable regulations, published rules or procedures, or written communications;

(c) to a legal representative of the Bureau personally and directly engaged in, and solely for use in, preparation for a civil or criminal proceeding (or investigation which may result in a proceeding) before a Possession administration body, grand jury, or court in a matter involving Possession tax administration, if the returns and return information satisfy one or more of the criteria established in section 6103(h)(4)(A), (B) or (C); and

(d) to an officer or employee of the Possession audit agency for the purpose of and only to the extent necessary in making an audit of the Bureau.

2.5 A Federal return or Federal return information may be disclosed in a judicial or administrative proceeding pertaining to Possession tax administration, but only if the criteria established in section 6103(h)(4)(A), (B) or (C) of the Code are met.

2.6 Notwithstanding any other provision of this section, the IRS will not disclose a Federal return or Federal return information under this section if such disclosure would identify a confidential informant or seriously impair a Federal civil or criminal tax investigation. The Bureau agrees that neither it nor its legal representatives will make any further use or disclosure of a Federal return or Federal return information disclosed to a Bureau Representative by the IRS if the IRs notifies the head of the Bureau in writing that such further use or disclosure would identify a confidential informant or seriously impair a Federal civil or criminal tax investigation. The Bureau further agrees that prior to the disclosure of any Federal return or Federal return information in a Possession judicial proceeding or to any party other than the taxpayer or his/her designee in a Possession administrative proceeding if the return or return information satisfies one or more of the criteria established in section 6103(h)(4)(A), (B) or (C) of the Code, the head or legal representative of the Bureau will notify in writing the Service Center Director or

Assistant Commissioner (International), from whom the return or return information was received, of the intention to make such disclosure. No officer, employee or legal representative shall disclose a Federal return or Federal return information in a Possession judicial or administrative proceeding if the Service Center Director or Assistant Commissioner (International) or their delegate, within 30 days following receipt of such written notice, informs the head or legal representative of the Bureau that such disclosure would identify a confidential informant or seriously impair a Federal civil or criminal tax investigation.

2.7 Additionally, the Bureau agrees that it will notify the Assistant Commissioner (International) when, during an audit of the Bureau by the Possession Audit Agency, Federal returns and Federal return information are disclosed to the Possession Audit Agency and such information is made part of the Possession Audit Agency's workpapers.

SECTION 3. Disclosure of Possession Returns and Possession Return Information

3.1 This Agreement and Appendix constitute the requisite authorization for the Bureau to disclose to, and permit inspection by, IRS Representatives of Possession returns and Possession return information for the purpose of, and only to the extent necessary in the administration of the internal revenue laws, or related statutes, of the United States. Any Possession returns and Possession return information so disclosed to, or inspected by, an IRS Representative become, in the hands of the IRS, "taxpayer return information" as defined by section 6103(b)(3) of the Code and may be redisclosed by the IRS only in accordance with provisions of the Code or an applicable treaty.

SECTION 4. Safeguards and Other Requirements

4.1 As an express condition for the inspection and disclosure of Federal returns and Federal return information, the Bureau agrees to comply with the safeguards and requirements prescribed by section 6103(p)(4) of the Code and any implementation of such safeguards and requirements as may be provided by regulations and published procedures including:

(a) furnishing an annual report to the IRS describing the procedures established and utilized by the Bureau for ensuring the confidentiality of such returns and return information;

(b) permitting the IRS to review the extent to which the Bureau is complying with the requirements of this paragraph; and

(c) informing in writing all Bureau Representatives and other persons to or by whom disclosure or inspection of Federal returns or Federal return information is authorized of the criminal penalties and civil liabilty provided by sections 7213 and 7431 of the Code for a disclosure of such returns and return information which is unauthorized by the Code.

4.2 As an express condition for the inspection and disclosure of Possession returns and Possession return information, the IRS agrees to comply with the safeguards and requirements prescribed by section 6103(p)(4) of the Code and any implementation of such safeguards and requirements as may be provided by regulations and published procedures.

4.3 Processing of Federal returns and Federal return information received by the Bureau from the IRS in the form of microfilms, photoimpressions, magnetic media or other format (including reformatting or reproduction, or conversion to magnetic media, punch cards, or hard copy printout) and transmission and storage of such Federal returns or Federal return information by or on behalf of the Bureau may be performed by Bureau owned and/or operated computer facilities, facilities shared by the Bureau with other Possession agencies, or by any other person described in section 6103(n) of the Code. In those cases where such facilities used by the Bureau are shared with other Possession agencies or operated by any other person described in section 6103(n) of the Code, the Bureau will insure the confidentiality of the Federal returns and Federal return information provided to such shared facility or person. As part of this responsibility, the terms of any contract or agreement between the Bureau and a shared computer facility or other person to whom Federal returns or Federal return information is or may be disclosed for a purpose described in this subsection, will provide, or will be amended to provide, that such person, and officers and employees of the person, will comply with the applicable safeguard conditions contained in regulations, published rules and procedures, or written communications.

4.4 Because some taxpayers may be unaware that Bureau tax officials are authorized under Federal law to obtain Federal returns and Federal return information for Possession tax administration purposes, the Bureau will publicize, in a manner satisfactory to the IRS, that such returns or return information were obtained pursuant to specific authority granted by the Code. Similar publicity will be provided by the IRS for Possession tax information furnished to the IRS pursuant to Possession law.

SECTION 5. Limitations

5.1 Pursuant to the provisions of section 6103(p)(2) of the Code, and of Possession law, if any, charges for furnishing returns and return information shall be governed by Article 5, paragraph 3 of the Agreement.

5.2 Under no circumstances will the Bureau permit any Federal return or Federal return information to be inspected by, or disclosed to an individual who is the chief executive officer of the Possession or any person other than one described in section 2 of this Appendix.

5.3 Notwithstanding any other provision of this Appendix, the IRS will not disclose or make known in any manner whatever to any person other than one described in Section 2 of this Appendix—

(a) any original, copy, or abstract of any return, payment, or registration made pursuant to chapter 35 of the Code (relating to taxes on wagering);

(b) any record required for making any such return, payment, or registration made or required pusuant to chapter 35 which the IRS is permitted by the taxpayer to examine or which is produced pursuant to section 7602 of the Code (relating to the examination of books and witnesses); or

(c) any information obtained by the exploitation of any such return, payment, registration, or record made or required pursuant to chapter 35.

5.4 Notwithstanding any other provision of this Agreement or Appendix, the Internal Revenue Service will disclose or make known in any manner to any person described in section 2 of this Appendix taxpayer information which was obtained pursuant to a tax convention or exchange of information agreement between the United States and a foreign government only if such disclosure is authorized by both the relevant convention or agreement and the Code.

SECTION 6. Officials to Contact for Obtaining Information

6.1 Requests by the Bureau for Federal returns and Federal return information should be made to the officials named below:

(a) Requests by the Bureau for Federal return information in magnetic media should be made to the Assistant Commissioner (International), Attn: Disclosure Officer, who will be responsible for coordinating the requests with the IRS National Office;

(b) Requests for physical inspection or copying of Federal returns, or requests for audit abstracts and reports pertaining to such returns, showing addresses within the possession should be made to the Director, Internal Revenue Service Center, Philadelphia, PA, Attn: Disclosure Officer, who will be responsible for making the proper arrangements for inspection or copying; and

(c) Requests by the head of the Bureau for Federal returns of taxpayers or Federal return information relating to taxpayers showing addresses outside the possession should be made to the Assistant Commissioner (International), Attn: Disclosure Officer.

6.2 Requests by authorized officers and employees of the IRS for inspection or copying of Possession Returns and Possession Return Information should be made to the Treasurer, American Samoa Government.

United States—The People's Republic of China Income Tax Convention[1]

Agreement and Related Protocol signed at Beijing on April 30, 1984; Second Protocol signed at Beijing on May 10, 1986; Ratification advised by the Senate of the United States of America on July 24, 1986;

Instruments of ratification exchanged on October 22, 1986; Entered into force on January 1, 1987.

AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF TAX EVASION WITH RESPECT TO TAXES ON INCOME

The Government of the United States of America and the Government of the People's Republic of China,

Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of tax evasion with respect to taxes on income,

Have agreed as follows:

ARTICLE 1

This Agreement shall apply to persons who are residents of one or both of the Contracting States.

ARTICLE 2

1. The taxes to which this Agreement applies are

(a) in the People's Republic of China:

(i) the individual income tax;

(ii) the income tax concerning joint ventures with Chinese and foreign investment;

(iii) the income tax concerning foreign enterprises;

(iv) the local income tax (herein after referred to as "Chinese tax").

(b) in the United States of America: the Federal income taxes imposed (hereinafter referred to as "United States tax").

2. The Agreement shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Agreement in addition to, or in place of, those referred to in paragraph 1. Within an appropriate time period, the competent authorities of the Contracting States shall notify each other of any substantial changes which have been made in their respective taxation laws.

ARTICLE 3

1. In this Agreement, unless the contact otherwise requires,

(a) the term "the People's Republic of China", when used in a geographical sense, means all the territory of the People's Republic of China, including its territorial sea, in which the laws relating to Chinese tax are in force, and all the area beyond its territorial sea, including the sea-bed and subsoil thereof, over which the People's Republic of China has jurisdiction in accordance with international law and in which the laws relating to Chinese tax are in force;

(b) the term "the United States of America", when used in a geographical sense, means all the territory of the United States of America, including its territorial sea, in which the laws relating to United States tax are in force, and all the area beyond its territorial sea, including the sea-bed and subsoil thereof, over which the United States of America has jurisdiction in accordance with international law and in which the laws relating to United States tax are in force;

---

[1] Protocol, page 421, Protocol, page 422, Senate Report No. 99-7, page 423, Senate Report No. 99-15 page 445, Treasury Department Technical Explanation, page 447.

(c) the terms "a Contracting State" and "the other Contracting State" mean the People's Republic of China or the United States of America, as the context requires;

(d) the term "tax" means Chinese tax or United States tax, as the context requires;

(e) the term "person" includes an individual, a company, a partnership and any other body of persons;

(f) the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;

(g) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;

(h) the term "nationals" means all individuals having the nationality of a Contracting State and all legal persons, partnerships and other bodies of persons deriving their status as such from the law in force in a Contracting State;

(i) the term "competent authority" means
  (i) in the People's Republic of China, the Ministry of Finance or its authorized representative; and
  (ii) in the United States of America, the Secretary of the Treasury or his authorized representative.

2. As regards the application of the Agreement by a Contracting State any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting State concerning the taxes to which the Agreement applies.

ARTICLE 4

1. For the purposes of this Agreement, the term "resident of a Contracting State" means any person who, under the laws of that Contracting State, is liable to tax therein by reason of his domicile, residence, place of head office, place of incorporation or any other criterion of a similar nature.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then the competent authorities of the Contracting States shall determine through consultations the Contracting State of which that individual shall be deemed to be a resident for the purposes of this Agreement.

3. Where by reason of the provisions of paragraph 1 a company is a resident of both Contracting States, then the competent authorities of the Contracting States shall determine through consultations the Contracting State of which the company shall be deemed to be a resident for the purposes of this Agreement, and, if they are unable to so determine, the company shall not be considered to be a resident of either Contracting State for purposes of enjoying benefits under this Agreement.

4. Where by reason of the provisions of paragraph 1 a company is a resident of the United States of America, and, under a tax agreement between the People's Republic of China and a third country is also a resident of that third country, the company shall not be considered to be a resident of the United States of America for purposes of enjoying benefits under this Agreement.

ARTICLE 5

1. For the purposes of this Agreement, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

(a) a place of management;

(b) a branch;

(c) an office;

(d) a factory;

(e) a workshop; and

(f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. The term "permanent establishment" also includes:

(a) a building site, a construction, assembly or installation project, or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than six months;

(b) an installation, drilling rig or ship used for the exploration or exploitation of natural resources, but only if so used for a period of more than three months; and

(c) the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where such activities continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any twelve month period.

4. Notwithstanding the provisions of paragraphs 1 through 3, the term "permanent establishment" shall be deemed not to include:

(a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

(f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs (a) through (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person, other than an agent of an independent status to whom paragraph 6 applies, is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that Contracting State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other Contracting State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph if it is shown that the transactions between the agent and the enterprise were not made under arm's-length conditions.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other Contracting State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

ARTICLE 6

1. Income derived by a resident of a Contracting State from real property situated in the other Contracting State may be taxed in that other Contracting State.

2. The term "real property" shall have the meaning which it has under the laws of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to real property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of real property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships and aircraft shall not be regarded as real property.

3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting or use in any other form of real property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

ARTICLE 7

1. The profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other Contracting State but only so much of them as is attributable to that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties or other similar payments or by way of interest on money lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties or other similar payments or by way of interest on money lent to the head office of the enterprise or any of its other offices.

4. Insofar as the tax law of a Contracting State provides with respect to a specific industry that the profits to be attributed to a permanent establishment are to be determined on the basis of a deemed profit, nothing in paragraph 2 shall preclude that Contracting State from applying those provisions of its law, provided that the result is in accordance with the principles contained in this Article.

5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

6. For the purpose of paragraphs 1 through 5, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

7. Where profits include items of income which are dealt with separately in other Articles of this Agreement, then the provisions of those Articles shall not be affected by the provisions of this Article.

ARTICLE 8

1. Where

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case the relationship between the two enterprises in their commercial or financial relations differs from that which would exist between independent enterprises, then any profits which, but for those conditions would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that Contracting State—and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other Contracting State, and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other Contracting State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be paid to the other provisions of this Agreement and the competent authorities of the Contracting States shall if necessary consult each other.

ARTICLE 9

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other Contracting State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the laws of that Contracting State, but if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed 10 percent of the gross amount of the dividends.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the taxation laws of the Contracting State of which the company making the distribution is a resident.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State, of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other Contracting State independent personal services from a fixed base situated therein, and the holding or other corporate rights in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or 13, as the case may be, shall apply.

5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other Contracting State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other Contracting State or insofar as the holding or other corporate rights in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other Contracting State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that other Contracting State.

ARTICLE 10

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other Contracting State.

2. However, such interest may also be taxed in the contracting State in which it arises and according to the laws of that Contracting State, but if the recipient is the beneficial owner of the interest, the tax so charged shall not exceed 10 percent of the gross amount of the interest.

3. Notwithstanding the provisions of paragraph 2, interest arising in a Contracting State and derived by the government of the other Contracting State, a political subdivision or local authority thereof, the Central Bank of that other Contracting State or any financial institution wholly owned by that government, or by any resident of the other Contracting State with respect to debt-claims indirectly financed by the government of that other Contracting State, a political subdivision or local authority thereof, the Central Bank of that other Contracting State or any financial institution wholly owned by that government, shall be exempt from tax in the first-mentioned Contracting State.

4. The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities, and income from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures.

5. The provisions of paragraphs 1, 2 and 3 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other Contracting State independent personal services from a fixed base situated therein, and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or 13, as the case may be, shall apply.

6. Interest shall be deemed to arise in a Contracting State when the payer is the government of that Contracting State itself, a political subdivision, a local authority or a resident of that Contracting State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and

such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.

7. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Agreement..

ARTICLE 11

1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other Contracting State.

2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that Contracting State, but if the recipient is the beneficial owner of the royalties, the tax so charged shall not exceed 10 percent of the gross amount of the royalties.

3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematographic films or films or tapes used for radio or television broadcasting, any patent, technical know-how, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein; or performs in that other Contracting State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or 13, as the case may be, shall apply.

5. (a) Royalties will be deemed to arise in a Contracting State when the payer is the government of that Contracting State itself, a political subdivision, a local authority or a resident of that Contracting State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.

(b) Where under subparagraph (a) royalties do not arise in one of the Contracting States, and the royalties related to the use of, or the right to use, the right or property in one of the Contracting States, the royalties shall be deemed to arise in that Contracting State.

6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right, or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Agreement.

ARTICLE 12

1. Gains derived by a resident of a Contracting State from the alienation of real property referred to in Article 6 and situated in the other Contracting State may be taxed in that other Contracting State.

2. Gains from the alienation of movable (personal) property forming part of the business assets of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, or of movable (personal) property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or together with the whole enterprise) or such a fixed base, may be taxed in that other Contracting State.

3. Gains derived by a resident of a Contracting State from the alienation of ships or aircraft operated in international traffic and of movable (personal) property pertaining to the operation of such ships or aircraft shall be taxable only in that Contracting State.

4. Gains from the alienation of shares of the capital stock of a company the property of which consists directly or indirectly principally of real property situated in a Contracting State may be taxed in that Contracting State.

5. Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of 25 percent in a company which is a resident of a Contracting State may be taxed in that Contracting State.

6. Gains derived by a resident of a Contracting State from the alienation of any property other than that referred to in paragraphs 1 through 5 and arising in the other Contracting State may be taxed in that other Contracting State.

ARTICLE 13

1. Income derived by an individual who is a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that Contracting State, unless he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities or he is present in that other Contracting State for a period or periods exceeding in the aggregate 183 days in the calendar year concerned. If he has such a fixed base or remains in that

other Contracting State for the aforesaid period or periods, the income may be taxed in that other Contracting State, but only so much of it as is attributable to that fixed base or is derived in that other Contracting State during the aforesaid period or periods.

2. The term "professional services" includes, especially, independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

ARTICLE 14

1. Subject to the provisions of Articles 15, 17, 18, 19 and 20, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that Contracting State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other Contracting State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

(a) the recipient is present in the other Contracting State for a period or periods not exceeding in the aggregate 183 days in the calendar year concerned; and

(b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other Contracting State; and

(c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other Contracting State.

ARTICLE 15

Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other Contracting State.

ARTICLE 16

1. Notwithstanding the provisions of Articles 13 and 14, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio, or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State, may be taxed in that other Contracting State.

However, income derived by a resident of a Contracting State as an entertainer or athlete from activities exercised in accordance with a special program for cultural exchange agreed upon by the governments of both Contracting States shall be exempt from tax by the other Contracting State.

2. Where income in respect of personal activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7, 13 and 14, be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised.

However, if those activities are exercised in accordance with a special program for cultural exchange agreed upon by the governments of both Contracting States, the income so derived shall be exempt from tax by that Contracting State.

ARTICLE 17

1. Subject to the provisions of paragraph 2 of Article 18, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that Contracting State.

2. Notwithstanding the provisions of paragraph 1, pensions and other payments made by the government, a political subdivision or a local authority of a Contracting State under its social security system or public welfare plan shall be taxable only in that Contracting State.

ARTICLE 18

1. (a) Remuneration, other than a pension, paid by the government or a political subdivision or a local authority of a Contracting State to an individual in respect of services rendered to that government or subdivision or authority shall be taxable only in that Contracting State.

(b) However, such remuneration shall be taxable only in the other Contracting State if the services are rendered in that other Contracting State and the individual is a resident of that other Contracting State who:

(i) is a national of that other Contracting State; or

(ii) did not become a resident of that other Contracting State solely for the purpose of rendering the services.

2. (a) Any pension paid by, or out of funds created by, the government or a political or a local authority of a Contracting State to an individual in respect of services rendered to that government or subdivision or authority shall be taxable only in that Contracting State.

(b) However, such pension shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that other Contracting State.

3. The provisions of Articles 14, 15, 16 and 17 shall apply to remuneration and pensions in respect of services rendered in connection with a business carried on by the government or a political subdivision or a local authority of a Contracting State.

ARTICLE 19

An individual who is, or immediately before visiting a Contracting State was, a resident of the other Contracting State and is temporarily present in the first-mentioned Contracting State for the primary purpose of teaching, giving lectures or conducting research at a university, college, school or other accredited educational institution or scientific research institution in the first-mentioned Contracting State shall be exempt from tax in the first-mentioned Contracting State for a period not exceeding three years in the aggregate in respect of remuneration for such teaching, lectures or research.

ARTICLE 20

A student, business apprentice or trainee who is, or was immediately before visiting a Contracting State, a resident of the other Contracting State and who is present in the first-mentioned Contracting State solely for the purpose of his education, training or obtaining special technical experience shall be exempt from tax in that Contracting State with respect to:

(a) payments received from abroad for the purpose of his maintenance, education study, research or training;

(b) grants or awards from a government, scientific, educational or other tax-exempt organization; and

(c) income from personal services performed in that Contracting State in an amount not in excess of 5,000 United States dollars or its equivalent in Chinese yuan for any taxable year.

The benefits provided under this Article shall extend only for such period of time as is reasonable necessary to complete the education or training.

ARTICLE 21

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Agreement shall be taxable only in that Contracting State.

2. The provisions of paragraph 1 shall not apply to income other than that from real property as defined in paragraph 2 of Article 6 if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other Contracting State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or 13, as the case may be, shall apply.

3. Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Agreement and arising in the other Contracting State may also be taxed in that other Contracting State.

ARTICLE 22

1. In the People's Republic of China, double taxation shall be eliminated as follows:

(a) Where a resident of China derives income from the United States, the amount of the United States income tax payable in respect of that income in accordance with the provisions of this Agreement shall be allowed as a credit against the Chinese tax imposed on that resident. The amount of credit, however, shall not exceed the amount of the Chinese tax computed with respect to that income in accordance with the taxation laws and regulations of China.

(b) Where the income derived from the United States is a dividend paid by a company which is a resident of the United States to a company which is a resident of China and which owns not less than 10 percent of the shares of the company paying the dividend, the credit shall take into account the United States income tax payable by the company paying the dividend in respect of the profits out of which the dividends are paid.

2. In the United States of America, in accordance with the provisions of the law of the United States, the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income:

(a) the income tax paid to China by or on behalf of such resident or citizen; and

(b) in the case of a United States company owning at least 10 percent of the voting rights in a company which is a resident of China and from which the United States company receives dividends, the income tax paid to China by or on behalf of the distributing company with respect to the profits out of which the dividends are paid.

For the purposes of this paragraph of this Agreement, the taxes referred to in paragraphs 1(a) and 2 of Article 2 shall be considered income taxes.

3. Income derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Agreement shall be deemed to arise in that other Contracting State

ARTICLE 23

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other Contracting State in the same circumstances are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, apply to persons who are not residents of one or both of the Contracting States.

2. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other Contracting State than the taxation levied on enterprises of that other Contracting State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

3. Except where the provisions of Article 8, paragraph 7 of Article 10 or paragraph 6 of Article 11 apply, interest, royalties and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned Contracting State.

4. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned Contracting State are or may be subjected.

ARTICLE 24

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Agreement, he may, irrespective of the remedies provided by the domestic

law of those Contracting States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 23, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of this Agreement.

2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case through consultation with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Agreement. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of this Agreement. They may also consult together for the elimination of double taxation in cases not provided for in this Agreement.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of paragraphs 2 and 3. To facilitate reaching a mutual agreement, the competent authorities of both Contracting States may meet for an oral exchange of opinions.

ARTICLE 25

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Agreement or of the domestic laws of the Contracting States concerning taxes covered by this Agreement insofar as the taxation thereunder is not contrary to this Agreement, in particular for the prevention of fraud or evasion of such taxes. The exchange of information is not restricted by Article 1. Any information received by a Contracting State shall be treated as secret and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by this Agreement. Such persons or Authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

(a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

(b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

(c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

ARTICLE 26

Nothing in this Agreement shall affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements.

ARTICLE 27

Each of the Contracting States shall notify the other Contracting State in writing, through diplomatic channels, upon the completion of their respective legal procedures to bring this Agreement into force. The Agreement shall enter into force on the thirtieth day after the date of the latter of such notifications and shall take effect as respects income derived during taxable years beginning on or after the first day of January next following the date on which this Agreement enters into force.

ARTICLE 28

This Agreement shall remain in force indefinitely, but either Contracting State may terminate the Agreement by giving notice to the other Contracting State in writing through diplomatic channels on or before June 30 in any calendar year after five years from the date on which this Agreement enters into force. In such event, the Agreement shall cease to have effect with respect to income derived during taxable years beginning on or after the first day of January of the year following that in which the notice of termination is given.

Done at Beijing on the 30th day of April, 1984, in duplicate, in the Chinese and English languages, the two texts having equal authenticity.

RONALD REAGAN
FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA
ZHAO ZIYANG
FOR THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA

PROTOCOL

TO THE AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF TAX EVASION WITH RESPECT TO TAXES ON INCOME

At the signing of the Agreement between the Government of the Untied States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income (hereinafter referred to as "the Agreement"), both sides have agreed upon the following provisions which form an integral part of the Agreement:

1. This Agreement shall not restrict in any manner any tax benefit which is or may hereafter be accorded in a Contracting State by the laws of that Contracting State or by any Agreement between the governments of the Contracting States.

2. Notwithstanding any provision of the Agreement, the United States may tax its citizens. Except as provided in paragraph 2 of Article 8, paragraph 2 of Article 17, and Articles 18, 19, 20, 22, 23, 24 and 26 of

this Agreement, the United States may tax its residents (as determined under Article 4).

3. The United States may impose its social security tax, its personal holding company tax and its accumulated earnings tax notwithstanding any provision of this Agreement. However, a Chinese company shall be exempt from the personal holding company tax or the accumulated earnings tax in the United States during a taxable year if during that taxable year the company is wholly-owned, directly or indirectly, either by one or more individuals who are residents of China (and who are not citizens of the United States) or by the Government of China or any wholly-owned agency thereof.

4. The term "person" as defined in Article 3 of the Agreement shall include an estate or a trust.

5. In applying paragraph 2 of Article 4 of this Agreement, the competent authorities of both Contracting States shall be guided by the rules contained in paragraph 2 of Article 4 of the United Nations Model Double Taxation Convention between Developed and Developing Countries.

6. For purposes of paragraph 3 of Article 11 of this Agreement, it is agreed by both sides that, in the case of royalties paid for the rental of industrial, commercial or scientific equipment, the tax shall be imposed on 70 percent of the gross amount of such royalties.

7. It is agreed by both sides that the competent authorities of the Contracting States may through consultation deny the benefits of Articles 9, 10 and 11 to a company of a third country if the company becomes a resident of a Contracting State for the principal purpose of enjoying benefits under this Agreement.

8. This Agreement shall not affect the application of the agreement between the two governments with respect to mutual exemption from taxation of transportation income of shipping and air transport enterprises, signed at Beijing on March 5, 1982.

Done at Beijing on the 30th day of April, 1984, in duplicate, in the Chinese and English languages, the two texts having equal authenticity.

RONALD REAGAN
FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA

ZHAO ZIYANG
FOR THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA

PROTOCOL

CONCERNING THE INTERPRETATION OF PARAGRAPH 7 OF THE PROTOCOL TO THE AGREEMENT BETWEEN THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA AND THE GOVERNMENT OF THE UNITED STATES OF AMERICA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF TAX EVASION WITH RESPECT TO TAXES ON INCOME, SIGNED AT BEIJING ON APRIL 30, 1984.

The Government of the People's Republic of China and the Government of the United States of America, desiring to conclude a Protocol in addition to the Agreement between them for the avoidance of double taxation and the prevention of tax evasion, and the supplementary Protocol attached thereto, have agreed as follows:

Both sides have agreed, with respect to the interpretation of Paragraph 7 of the Protocol to the Agreement, that their understanding is as follows:

1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Agreement to relief from taxation in the other Contracting State unless:

(a)(i) more than 50 percent of the beneficial interest in such person (or in the case of a company more than 50 percent of the number of shares of each class of the company's shares) is owned, directly or indirectly, by any combination of one or more of:

(A) individuals who are residents of one of the Contracting States;

(B) citizens of the United States;

(C) companies as described in subparagraph 1(b) of this protocol; and

(D) one of the Contracting States, its political subdivisions or local authorities; and

(ii) in the case of relief from taxation under Articles 9 (dividends), 10 (interest), and 11 (royalties), not more than 50 percent of the gross income of such person is used to make payments of interest to persons who are other than persons described in clauses (A) through (D) of subparagraph (a)(i), whether directly or indirectly; or

(b) it is a company which is a resident of a Contracting State and in whose principal class of shares there is substantial and regular trading on a recognized stock exchange.

2. Paragraph 1 shall not apply if the establishment, acquisition and maintenance of such person and the conduct of its operations did not have as a principal purpose the purpose of obtaining benefits under the Agreement.

3. For the purposes of paragraph 1(b), the term "a recognized stock exchange" means:

(a) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934; and

(b) any national securities exchange approved to be established by the Government of the People's Republic of China or its authorized institution; and

(c) any other stock exchange agreed upon by the competent authorities of the Contracting States.

4. Before a resident of a Contracting State is denied relief from taxation in the other Contracting State by reason of paragraph 1, 2 and/or 3, the competent authorities of the Contracting States shall consult each other.

This Protocol is certified for addition to the Agreement and its supplemental Protocol by the undersigned.

Done at Beijing on the 10th day of May, 1986, in duplicate, in the English and Chinese languages, the two texts having equal authenticity.

James A. Baker, III
Secretary of the
Treasury United
States of America

Wang Bingqian,
State Councillor and
Minister of Finance
People's Republic of
China

SENATE EXECUTIVE REPORT NO. 99-7

INCOME TAX AGREEMENT (AND PROTOCOL) WITH THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA

DECEMBER 11 (legislative day, DECEMBER 9), 1985.—Ordered to be printed

Mr. EVANS, from the Committee on Foreign Relations, submitted the following report to accompany Treaty Doc. 98-30.

The Committee on Foreign Relations, to which was referred the Agreement Between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, together with a Supplementary Protocol and Exchange of Notes, signed at Beijing on April 30, 1984, having considered the same, reports favorably thereon and recommends that the Senate give its advice and consent to ratification thereof.

I. PURPOSE

The principal purposes of the proposed income tax treaty between the United States and the Government of the People's Republic of China are to reduce or eliminate double taxation of income earned by citizens and residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to continue to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

II. BACKGROUND

The proposed treaty and protocol were both signed on April 30, 1984. The proposed treaty was amplified by an exchange of notes signed the same day.

The proposed treaty is the first comprehensive income tax treaty between the United States and the People's Republic of China. An agreement between the two countries governing the taxation of shipping and aircraft income only was signed on March 5, 1982, and is currently in force. The proposed treaty does not alter the tax rules for shipping and aircraft income set forth in that prior agreement.

The treaty was transmitted to the Senate for advice and consent to its ratification on August 10, 1984. The Senate Committee on Foreign Relations held a public hearing on the proposed treaty and protocol on July 30, 1985.

III. SUMMARY OF TREATY (AND PROTOCOL)

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty ("U.S. model treaty"), and the model income tax treaty of the Organization for Economic Cooperation and Development ("OECD model treaty"). However, there are certain deviations from those documents.

As in other U.S. tax treaties, the objectives of the treaty are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty provides that neither country will tax business income derived from sources within that country by residents of the other unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 13). Similarly, the treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other will not be required to pay tax in the other unless their contact with the other exceeds specified minimums (Articles 13, 14, and 16). The proposed treaty provides that dividends, interest, royalties, capital gains, and certain other income derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 9, 10, 11 and 12). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis (Articles 9, 10, and 11).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief of the potential double taxation by the country of residence allowing a foreign tax credit.

Like other U.S. tax treaties, the proposed protocol contains a "saving clause." Under this provision, the United States retains the right to tax its citizens and residents as if the treaty had not come into effect. In addition, the protocol contains the standard provision that the treaty will not be applied to deny any taxpayer any benefits he would be entitled to under the domestic law of the country or under any other agreement between the two countries; that is, the treaty will only be applied to the benefit of taxpayers.

The proposed treaty differs in certain respects from other U.S. income tax treaties and from the U.S. model treaty. Some of these differences are as follows:

(1) At China's request, the proposed treaty has been designated an "agreement." Generally, tax treaties rendered in English are designated "conventions." This difference in terminology does not have any substantive significance.

(2) U.S. citizens who are not also U.S. residents are not generally covered by the treaty. The U.S. model does cover such U.S. citizens. However, the United States has rarely been able to negotiate coverage for nonresident citizens.

(3) Under the proposed treaty, the competent authorities of the United States and China are, through consultations, to determine a single resi-

dence for a company that is a resident of both countries under local law. The treaty does not specify criteria for the competent authorities to follow in making the determination. If the competent authorities are unable to determine a single residence, the company will not be considered a resident of either country and, thus, will be ineligible for treaty benefits. In addition, a company that is both a U.S. resident, under U.S. law, and a third-country resident, under a tax agreement between a third country and China (because, for example, the company is considered to be managed in the third country), will not be considered a U.S. resident for purposes of enjoying the benefits of the proposed treaty. Thus, such a company will be entitled to benefits granted by China in its agreement with the third country. The U.S. model treaty contains different rules for dual resident corporations. Under the U.S. model, a corporation that is a resident of both the United States and its treaty partner under local law is automatically considered a resident of the country under whose laws it was first created and is thus entitled to the same treaty benefits that other corporate residents of that country receive. Further, a U.S.-incorporated company that is a resident of another treaty partner of the United States' treaty partner is not denied U.S. treaty benefits.

The first of the proposed treaty's two dual corporate resident rules technically permits determinations of a single corporate residence that would be inconsistent with the U.S. tax policy of not restricting, by treaty, U.S. taxation of U.S. corporations. The competent authorities of the two countries are free, for example, to decide that a company incorporated in the United States and, therefore, resident in the United States under U.S. law, and resident in China under Chinese law should be treated as a Chinese resident for treaty purposes. In the event of such a determination, the United States would be obligated to extend treaty reductions in U.S. tax to the U.S.-incorporated company. Such a determination would also deprive the U.S. corporation of the treaty reductions in Chinese tax otherwise available to U.S. corporations. The Committee understands, however, that the U.S. competent authority has never agreed to treat a U.S.-incorporated company as a resident of another country under existing treaties, and does not intend to agree to such treatment in the future. The Treasury Department's Technical Explanation is in accord with this understanding.

The first dual corporate resident rule also might result in the denial of treaty benefits to a company resident in both China and the United States under local law. This is the result in several other U.S. tax treaties. It might tend to encourage such a company to establish a single residence in one of the countries in order to ensure treaty coverage.

The second dual corporate resident rule does not appear in any existing U.S. income tax treaty. It may complicate the planning of U.S. multinationals in certain cases. For example, it is possible that a U.S. corporation operating in China might inadvertently lose its benefits under the proposed treaty if it opens a branch in a third country where it is then treated as a resident under a treaty between that country and China. The rule might encourage a U.S. corporation considered to be managed in and, therefore, a resident of another Chinese treaty partner to establish a single residence in the United States in cases where the benefits provided to the U.S. corporation under the third-country treaty with China fall short of the benefits available to U.S. corporate residents under the proposed treaty.

(4) The proposed treaty does not have an article governing the taxation of shipping and aircraft income. Rules for shipping and aircraft income are provided in a separate shipping and aircraft income tax agreement between the two countries signed on March 5, 1982, and currently in force.

(5) The definition of a permanent establishment in the proposed treaty is somewhat broader than that in the U.S. model and in many existing U.S. treaties. The principal areas in which the proposed treaty departs from the U.S. model are the inclusion as a permanent establishment of a building site or construction, assembly, or installation project that continues for more than six months, and the inclusion as a permanent establishment of an installation, drilling rig, or ship that is used for more than three months for the exploration or exploitation of natural resources (rather than, in each case, the U.S. model's 12 months). In addition, engaging in supervisory activities in connection with building sites, etc. for more than six months, or furnishing services, including consultancy services, through personnel engaged for that purpose, for more than six months in any twelve-month period (even without a fixed place of business), would create permanent establishment status under the proposed treaty but not under the U.S. model. An independent agent of an enterprise will constitute a permanent establishment under the proposed treaty if the agent's activities are devoted wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise are not made under arm's-length conditions; the U.S. model does not contain this rule though a few U.S. tax treaties with developing countries do.

(6) The proposed treaty differs from the U.S. model in not providing investors in real property in the country not of their residence with an election to be taxed on such investments on a net basis. However, current U.S. law provides foreign persons with such an election.

(7) The proposed treaty does not contain a definition of "business profits," although certain categories of business profits are defined in various articles. This leaves to local law the definition of that term in some cases. Business profits must be attributed to a permanent establishment before they can be taxed by the country where the permanent establishment is located.

Many U.S. treaties, and the U.S. model, define business profits to include income from rental of tangible personal property and income from rental or licensing of films or tapes. The absence of such an inclusion in the proposed treaty means that persons who earn such rental or licensing income could be subject to tax in the source country on a gross basis rather than on a net basis unless they maintain a permanent establishment there.

(8) The proposed treaty contains rules not specifically found in business profits of a permanent establishment. For example, the proposed

treaty disallows any deduction for interest paid (other than in reimbursement of actual expenses) by a permanent establishment to its head office on money lent to the permanent establishment. These rules are patterned after rules contained in the United Nations model treaty; however, the United Nations model exempts branch banks from the prohibition on the deduction of interest paid to a permanent establishment's head office. Rules similar to those of the proposed treaty are specifically included in certain other U.S. income tax treaties with developing countries, and generally the same result is reached by the U.S. model treaty.

The proposed treaty also provides that a country may determine profits attributable to a permanent establishment on a deemed basis if, under its internal law, it does so with respect to other entities in that permanent establishment's industry and if the result is in accordance with the principles contained in the business profits article. Most recent U.S. income tax treaties and the U.S. model treaty do not contain this provision. The Committee understands that it is generally China's practice to deem as taxable profits 10 percent of the Chinese source gross receipts of U.S. subcontractors from offshore oil operations. The Committee also understands that China deems as taxable profits 10 percent of the Chinese source gross receipts with respect to outgoing traffic received by operators of ships and aircraft in international traffic. In both cases, a 50-percent tax is imposed on the deemed profits. However, under the agreement currently in force between the United States and China governing the taxation of shipping and aircraft income, income earned by a U.S. enterprise from the operation of ships or aircraft in international traffic is exempt from Chinese tax.

(9) The limit on the gross dividend tax that the country of source may impose is 10 percent, in contrast with the five percent limit for direct dividends and 15 percent limit for portfolio dividends in the U.S. model.

(10) The U.S. model treaty allows one country to tax dividends paid by a resident company of the other country from profits of its permanent establishment in the first country constituting 50 percent or more of the company's worldwide income. The proposed treaty allows one country to tax dividends paid by a resident company of the other only when the dividends are (a) paid to a resident of the first country of (b) with respect to a stock holding or other corporate right effectively connected with a permanent establishment or a fixed base in the first country. This variation from the U.S. model has the effect of prohibiting the United States from imposing its "second tier" withholding tax on dividends (see Code sec. 861(a)(2)(B)) paid by any Chinese company that in the future earns significant business profits in the United States. The proposed treaty, unlike the U.S. model, also expressly prohibits a country from taxing the undistributed profits of a company resident in the other country.

(11) The proposed protocol prohibits the United States from imposing its personal holding company and accumulated earnings taxes on Chinese companies that are wholly owned by either the Chinese government or individual residents of China (who are not U.S. citizens). The personal holding company and accumulated earnings taxes are not covered taxes under the U.S. model treaty and, thus, their imposition is not limited by the model.

(12) The proposed treaty generally limits the tax at source on gross interest to 10 percent; interest derived by the governments of the countries, by certain government financial institutions, and by individuals on debt-claims indirectly financed by the foregoing entities is exempt from source country tax. Under the U.S. model, all interest, by contrast, generally is exempt from source country withholding tax. The U.S. model position is rarely achieved.

Because of the recent repeal (in the Tax Reform Act of 1984) of the U.S. gross withholding tax on interest paid on portfolio indebtedness held by foreign persons, Chinese residents generally will receive U.S. source interest on portfolio indebtedness free of U.S. tax in any event. However, U.S. residents generally will be subject to Chinese tax (limited to 10 percent by the treaty) on Chinese source interest on similar indebtedness, subject to certain exemptions.

(13) The proposed treaty generally limits the tax at source on gross royalties, including movie royalties, to 10 percent. In the case of royalties paid for the rental of industrial, commercial, or scientific equipment, the proposed protocol further reduces the maximum rate to seven percent. The U.S. model exempts royalties from source country tax.

(14) The proposed treaty limitations on source country withholding tax on dividends, interest, and royalties paid to residents of the other country apply, by their terms, only if the recipient of the income is also its beneficial owner. Under the U.S. model treaty, by contrast, these limitations on source country withholding tax generally apply so long as the beneficial owner of the income resides in the nonsource country; in that case, initial receipt of the income by an intermediary that is not the beneficial owner is irrelevant.

The proposed treaty language is similar to that of the OECD model treaty. The commentaries on the OECD model indicate that this language should not be interpreted to deny the reduced source country withholding tax rates to dividend, interest, or royalty payments received by a nominee or other agent of the beneficial owner when the beneficial owner is a resident of the nonsource country. The Committee understands that the countries intend the language to be interpreted in a manner consistent with the OECD commentaries, and recommends approval of the treaty only on that basis.

(15) The proposed treaty allows source country taxation of most capital gains, including gains on the disposition of real estate. The treaty's rules preserve U.S. tax under the Foreign Investment in Real Property Tax Act of 1980. The U.S. model generally permits source country taxation of real estate gains and gains from the alienation of personal property attributable to a permanent establishment or fixed base in the source country, but prohibits other source country taxation of capital gains.

(16) The proposed treaty allows source country taxation of independent professional services income on the basis of presence in the source country for more than 183 days in a calendar year. The U.S. model treaty does not allow taxation of such income on the basis of days of pres-

ence. Under the U.S. model, independent personal services income of a nonresident is taxable only if the nonresident has available a fixed base in the source country.

(17) The proposed treaty allows directors' fees derived by a resident of one country in his capacity as a member of the board of directors of a company which is a resident of the other country to be taxed in that other country. The U.S. model treaty, on the other hand, treats directors' fees as personal service income or as a distribution of profits. Under the U.S. model treaty (and the proposed treaty), the country where the recipient resides generally has primary taxing jurisdiction over personal service income and the source country tax on distributed profits is limited.

(18) Under the proposed treaty, source country taxation of income derived by entertainers and athletes from their activities as such is not permitted if the income is derived in accordance with a special program for cultural exchange agreed upon by the U.S. and Chinese Governments. The Committee understands that U.S. entertainers and athletes presently perform in China (and Chinese entertainers and athletes presently perform in the United States) only in accordance with such special programs. Under the U.S. model treaty, entertainers and athletes may not be taxed in the source country unless they earn more than $20,000 there during a taxable year. Most U.S. income tax treaties follow the U.S. model approach, with a lower annual income threshold for taxation than the U.S. model contains.

(19) The proposed treaty does not limit taxation of annuities, alimony, or child support payments. The U.S. model treaty allows taxation of annuities and alimony payments only in the country of residence of the recipient, and taxation of child support payments only in the country of residence of the payor.

(20) Under the proposed treaty, the salaries of visiting teachers and researchers are exempt from tax in the source country for three years. Under the U.S. model, these salaries are subject to the standard rules, ordinarily resulting in full source country taxation. A number of existing U.S. income tax treaties provide visiting teachers and researchers with a two-year exemption from source country taxation.

(21) The exemption from source country taxation provided to visiting students and trainees is broader than that provided in the U.S. model. The U.S. model exemption applies only to payments received from outside the source country for maintenance, education, study, research, or training. The proposed treaty exemption extends to, among other things, grants and awards from governmental and other tax-exempt organizations and $5,000 per year of personal services income. The proposed treaty exemption is similar to that incorporated in some other U.S. income tax treaties with developing countries; it differs, however, from the exemptions provided in those treaties in not terminating after a fixed number of years (typically five).

(22) The proposed treaty allows the source country to tax any income not otherwise specifically dealt with under the treaty. The U.S. model treaty, by contrast, gives the residence country the sole right to tax income not otherwise specifically dealt with under the treaty, unless the income is attributable to a permanent establishment or a fixed base in the other country. The rule of the proposed treaty is contained in a number of existing U.S. income tax treaties.

(23) The proposed treaty's nondiscrimination provision differs from the U.S. model treaty's in protecting all legal persons deriving their status as such from the United States, not U.S. citizens alone. The rule of the proposed treaty is contained in a number of existing U.S. income tax treaties.

(24) The proposed treaty's exchange of information provision generally follows that of the U.S. model, but is somewhat narrower in scope. The U.S. model treaty provides for the exchange of information relating to taxes of every kind imposed by the two countries. The proposed treaty provides for the exchange of information relating only to taxes it covers. The U.S. model treaty requires that, upon an appropriate request for information, the requested country obtain the information to which the request relates in the same manner and to the same extent as if its tax were at issue. It also requires that, where specifically requested by the competent authority of one country, the competent authority of the other country provide the information in the form requested. The proposed treaty does not include these requirements. In addition, the U.S. model treaty provides that each country will collect taxes for the other country to the extent necessary to insure that benefits of the treaty are not going to persons not entitled to those benefits. The proposed treaty does not contain this collection rule.

The proposed treaty, like the U.S. model, makes it clear that the appropriate Congressional Committees and the General Accounting Office are to have access to information exchanged under the treaty where appropriate.

(25) The "saving clause" (added by the proposed protocol) differs in certain respects from that found in the U.S. model treaty and those found in most recent U.S. income tax treaties. The principal differences are: Under the U.S. model treaty, both countries generally reserve the right to tax their citizens and residents as if the treaty had not come into effect; under the proposed protocol, only the United States does. Under the U.S. model treaty, there are several exceptions to this reservation of taxing rights; under the proposed protocol, the United States reserves the right to tax its citizens without exception. The U.S. model contains a provision specifically retaining a country's right to tax former citizens who renounced citizenship to avoid income tax; the proposed treaty does not, but no difference in meaning is intended.

(26) The proposed treaty's anti-treaty shopping provision (added by the proposed protocol) is considerably less comprehensive than that of the U.S. model treaty and most recent U.S. income tax treaties. (See discussion under "Committee Comments," below.)

(27) In notes exchanged at the signing of the proposed treaty and protocol, the United States and China agreed that a tax sparing credit would not be provided at the present time. However, the countries agreed that the proposed treaty would be promptly amended to incorporate a tax sparing credit provision if, in the future, the United States amended its laws concerning the provision of tax

sparing credits, or the United States reached agreement on the provision of a tax sparing credit with any other country. This agreement is similar to, but goes somewhat beyond, existing agreements between the United States and certain developing countries regarding the reduction of conflicts between the U.S. tax system and the developing country's foreign investment tax incentives. The existing agreements do not refer explicitly to a tax sparing credit and do not include a promise by the Untied States to allow such a credit upon allowing it to any other country, i.e., they do not confer most favored nation status on the U.S. treaty partner in connection with the tax sparing credit. Generally, the existing agreements commit the United States only to resume discussions, when circumstances permit, with a view to incorporating provisions in the treaty that will minimize interference with incentives offered by the other country and be consistent with U.S. income tax policy vis a vis other developing countries. Any future amendment of the proposed treaty to provide a tax sparing credit, like any treaty amendment, would be subject in any event to the full negotiation and Senate ratification processes that apply to treaties generally.

(28) Income derived by a resident of one country that may be taxed in the other country under the proposed treaty is deemed to arise in that other country for purposes of the proposed treaty. However, the proposed treaty omits the U.S. model provision stating that this source rule does not apply in determining foreign tax credits for foreign taxes paid by U.S. residents to third countries.

IV. DATE OF ENTRY INTO FORCE AND TERMINATION

Entry into force

The countries are to notify each other in writing, through diplomatic channels, upon the completion of their respective legal procedures to bring the proposed treaty into force. The proposed treaty and protocol will enter into force on the 30th day after the latter of the notifications.

The proposed treaty and protocol will be effective for income derived in taxable years beginning on or after the January 1st next following the date on which the treaty and protocol enter into force.

Termination

This proposed treaty will remain in force indefinitely, but either country may terminate it by giving notice in writing through diplomatic channels on or before June 30th in any calendar year after five years from the date on which the treaty enters into force. If a termination occurs, it will be effective with respect to income derived during taxable years beginning on or after the January 1st of the year following that in which the notice of termination is given.

V. COMMITTEE ACTION

The Committee on Foreign Relations held public hearings, chaired by Senator Evans, on the proposed Chinese income tax treaty and protocol, and on other proposed tax treaties, on July 30, 1985. The Committee considered the proposed treaty and protocol on December 4, and December 11, 1985, and ordered them favorably reported on December 11, 1985, by voice vote.

VI. COMMITTEE COMMENTS

The Committee on Foreign Relations approved the treaty without reservation, but expressed its understanding of the effect of the treaty on the U.S. foreign tax credit limitation as amended by the Tax Reform Act of 1984. In addition, the Committee expressed its concern with respect to three other issues raised by the proposed treaty.

Resourcing rule of the Tax Reform Act of 1984

The Tax Reform Act of 1984 amended the foreign tax credit limitation rules to prevent U.S. persons from treating as foreign source income dividends, interest, and certain other income that they derived through a foreign corporation a significant part of whose income arose in the United States. The proposed treaty provides that the United States need credit taxes paid to China only "in accordance with the provisions of the law of the United States" (Article 22, paragraph 2). The proposed treaty also provides that income derived by a resident of one country which may be taxed in the other country under the treaty is deemed to arise in that other country (Article 22, paragraph 3).

Some have questioned whether the proposed treaty allows the 1984 change to the foreign tax credit limitation rules to operate as Congress intended. The proposed treaty would prevent operation of the 1984 change if that change were viewed as a source rule for purposes of the treaty. However, the Committee believes that the 1984 change is a limitation on the foreign tax credit (for the purpose of the treaty provisions listed above), and therefore paragraph 2 of Article 22 controls. Thus, the proposed treaty does not prevent operation of the change, since the treaty credit is to be granted only "in accordance with the provisions" of U.S. law. The Committee believes that because the 1984 Act amended a Code section (sec. 904) that deals only with the foreign tax credit limitation, that amendment should be viewed as a foreign tax credit limitation rule and not a source rule.

The chairmen and ranking minority members of the tax law writing committees of Congress emphasized in letters to this Committee the importance of clarifying that the proposed treaty does not override the 1984 changes to the foreign tax credit limitation. Therefore, to make it clear that no such override is accomplished by Article 23 of the proposed treaty, the Committee states that it has recommended approval of the treaty based on its understanding that nothing in Article 23 will be interpreted to prevent the United States from determining the source of income (for purposes of the foreign tax credit limitation) in accordance with the provisions of section 904(g) of the Internal Revenue Code. The Committee would not recommend approval of this treaty if it overrode the 1984 Act in this respect.

The Committee thus intends that payments from a U.S.-owned Chinese corporation will be treated as U.S.-source for U.S. foreign tax credit purposes if the income of the corporation is from U.S. sources, in accordance with section 904(g) of the Code. The Committee stresses, however, that its clarification in this manner of a newly ratified treaty does not support a contrary reading of any previously ratified treaty. In enacting the 1984 Act, Congress intended that the credit article of any existing treaty be applied subject to the limitations imposed by the Act.

Developing country concessions

The proposed treaty contains a number of developing country concessions. Many of these concessions are found in the United Nations model income tax treaty between developed and developing countries and in other U.S. tax treaties with developing countries.

Developing country concessions generally

The proposed treaty departs significantly from the U.S. and OECD model treaties in providing for relatively broad source basis taxation. The proposed treaty's permanent establishment clause, for instance, permits the country in which business activities are carried on to tax the activities sooner, in certain cases, than it would be able to under the U.S. or OECD model treaty. Under the proposed treaty, the use of a drilling rig in a country for more than three months creates a permanent establishment there; under the U.S. model, drilling rigs must be present for at least one year. Thus, under the proposed treaty, business profits attributable to a U.S. drilling rig located in Chinese waters in the South China Sea, for example, will be taxable by China if the rig stays there for more than three months. Certain construction activities create a permanent establishment under the proposed treaty if they continue in a country for more than six months, in contrast with the 12-month threshold in the U.S. model. Also, under the proposed treaty, unlike the U.S. model, the performance of certain supervisory services in connection with building sites, etc., or the performance of certain consulting and other services though personnel engaged by an enterprise for that purpose (even if the enterprise has no fixed place of business in the country of performance) can, by itself, create a permanent establishment. The practical effect of these rules could be greater Chinese taxation of U.S. mineral exploration activities, construction activities, and consulting services than would be the case if the model treaty rules were used.

Other concessions to source basis taxation in the proposed treaty include maximum rates of source country tax on direct dividends, interest, and royalties that, while in line with those provided in some other treaties with developing countries, are higher than those provided in the U.S. model treaty and some U.S. treaties; allowing taxing jurisdiction on the part of the source country as well as the residence country with respect to income not otherwise specifically dealt with by the treaty; and broader source country taxation of independent personal services income, directors' fees, and entertainers' income than that allowed by the U.S. model.

The Committee expressed its concern that such provisions not be viewed as the starting point for future negotiations with developing countries. It must be clearly recognized that several of the rules of the proposed treaty represent substantial concessions by the United States, and that such concessions must be met (as they are in this case) with substantial concessions by the treaty partner. Thus, future negotiations with developing countries should not assume, for example, that the definition of a permanent establishment provided in this treaty will necessarily be available in every case; rather, such a definition will only be adopted in the context of an agreement that satisfactorily addresses the concerns of the United States.

Different permanent establishment rules for drilling and construction activities

As indicated above, the proposed treaty defines a permanent establishment to include a drilling rig used for the exploration or exploitation of natural resources in a country if it is so used for more than three months. This treatment contrasts with the treaty's six-month permanent establishment rule for construction activities. In its 1984 report on the income tax treaty with Canada, the Committee expressed its view that the offshore activities of contract drillers are, as a general matter, closely analogous to construction activities.[1] The Committee indicated its strong belief that the permanent establishment threshold for drilling contractors should be the same as that provided for enterprises engaged in construction activities.[2] The proposed treaty once again presents the issue whether unequal treatment for drilling rigs and construction activities is acceptable. The Committee believes that the United States should not generally make concessions of this kind, especially in light of the Committee's comments just over a year ago. On the other hand, the proposed treaty with China was signed before the Committee made the comments described above. Therefore, the Committee will accept unequal treatment in this unusual case. However, the Committee wishes to make it clear that a future treaty provision containing different permanent establishment thresholds for drilling rigs and construction activities will bear a substantial risk of Committee disapproval.

Treaty shopping

The proposed treaty, like a number of U.S. income tax treaties, generally limits source country withholding tax on interest paid to residents of the other country. Although this treaty tax reduction (like other tax reductions and tax exemptions provided in the proposed treaty) is intended to benefit residents of China and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the Untied States, or from countries that have not agreed in their tax treaties with the United States to limit source country taxation of interest to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of U.S. tax on interest by lending money to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may do this by establishing a subsidiary, trust, or other investing entity in that treaty country, which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

By repealing the U.S. gross withholding tax on interest paid to foreigners on certain portfolio indebtedness, the Tax Reform Act of 1984 limited treaty shopping incentives dramatically. Opportunities for treaty shopping remain, however, where the United States still imposes tax on interest paid to foreigners or with respect to other types of payments. For example, the United States taxes interest paid to parties related to the payor, interest on pre-July 19, 1984, debt, and certain interest paid to banks.

---

[1] Tax Convention and Proposed Protocols with Canada. Report of the Senate Committee on Foreign Relations, Exec. Rep. No. 98-22 May 21, 1984, p. 7-8.

[2] Id.

The anti-treaty shopping provision of the proposed treaty (added by the proposed protocol) is much less detailed than the anti-treaty shopping provision of the current (1981) U.S. model treaty, or the provisions found in most recent U.S. treaties. It is considerably less strict than the anti-treaty shopping provision of the current U.S. model. While the U.S. model provision is only one of several approaches that the Treasury Department considers satisfactory to prevent treaty shopping abuses, the model provision is nonetheless a standard against which to compare the proposed treaty's anti-treaty shopping provision.

Under the proposed treaty provision, only treaty benefits provided under the dividend, interest, and royalty articles (chiefly reduced source country withholding tax rates) may be denied; under the U.S. model provision, all treaty benefits may be denied. The proposed treaty provision applies to companies only; the U.S. model treaty provision applies to all persons except individuals, that is, all business organizations. The proposed treaty provides that the competent authorities of the two countries "may through consultation deny" treaty benefits. The U.S. model's anti-treaty shopping provision does not contain language referring to consultations by the competent authorities. The Committee is aware that some have argued that, under this language, if the Chinese competent authority, for example, fails to cooperate, the United States will be unable to prevent third-country residents from obtaining treaty reductions in U.S. tax through the use of an investing entity set up in China. However, the Committee concurs with the Treasury Department's view that treaty benefits could be denied under the anti-treaty shopping rules without prior consultations by the competent authorities. Under the proposed treaty, sanctions against treaty shopping may be imposed only if a company formed in a third country becomes a resident of one of the countries for the principal purpose of enjoying the proposed treaty's benefits; under the U.S. model, sanctions may be imposed, in addition, if certain objective tests concerning stock ownership and the use of funds are not satisfied.

Under the U.S. model "safe harbor" tests, treaty benefits will be denied to a business organization unless it is owned 75 percent or more by individuals residing in the country of which it is a resident, and its income is not used in substantial part to meet liabilities to persons residing in third countries who are not U.S. citizens. The proposed treaty does not apply such a safe harbor test; it provides no standard for denying treaty benefits other than the rule that benefits may be denied if a company becomes a resident for the principal purpose of obtaining them. The safe harbor test of the U.S. model has the advantage of providing both business organizations and the countries with relative certainty as to who will be denied treaty benefits. On the other hand, the safe harbor test may limit the countries' flexibility in attacking treaty shopping uses. Thus, the omission of the test from the anti-treaty shopping provision of the proposed treaty may, in this respect, benefit the countries' taxing authorities.

Finally, unlike the U.S. model, the proposed treaty does not limit treaty benefits with respect to foreign source income of a country's residents that bears a significantly lower tax in the residents' home country, under its laws, than similar domestic source income.

The Committee is therefore concerned that the proposed treaty's anti-treaty shopping provision may not prevent all potential unintended uses of the treaty by third-country investors. On the other hand, the Committee recognizes that treaty shopping possibilities in China appear insignificant at present. In general, Chinese taxes on foreign investors are relatively high (though tax holidays to encourage investment are available). Interest and dividend payments to foreign enterprises are subject to withholding tax. With certain exceptions, interest and dividend payments to foreign individuals are subject to the individual income tax.[3] The Committee has been informed that foreign entities in China are subject to registration requirements that, as they are presently administered, effectively preclude the establishment of entities that would function primarily as passive investment vehicles. In addition, foreign exchange controls presently in place make it difficult for third-country investors to channel investment income from the United States through China.

However, there is no guarantee that the present impediments to use of the proposed treaty by third-country investors will continue in the future. Changes in Chinese law and administrative practice with respect to foreign investors have been occurring at a rapid pace in recent years, and could continue to do so. Thus, the Committee emphasizes that any such changes in Chinese law would require the United States to carefully reexamine the adequacy of the treaty's anti-treaty shopping provision, and to take whatever steps are necessary to ensure that the treaty does not provide opportunities for treaty shopping.

China has announced its intention to resume the exercise of sovereignty over Hong Kong in 1997 and has concluded an agreement with Britain governing the resumption of sovereign control. Based on the terms of that agreement as they related to the treaty definition of "China," the proposed treaty will not apply to Hong Kong. (See discussion under Article 3.) The exclusion of Hong Kong from treaty coverage is important because treaty shopping possibilities in Hong Kong, in contrast with China, could be significant. As an international finance center seeking to attract foreign investment, Hong Kong generally imposes low income taxes. Profits earned overseas (for example, in the United States) generally are not included in arriving at taxable profits. Also, dividends paid by Hong Kong companies, income derived from trusts, and interest paid on Hong Kong bank deposits generally are exempt from Hong Kong tax. Hong

---

[3] It should be noted, however, that apparently no withholding mechanism for collecting the tax is presently in place. Also, the treaty substantially limits the tax; gross dividends, for example, are subject to a maximum tax of 10 percent, an unusually low treaty limit for portfolio dividends.

Kong has no exchange controls or other rules that would restrict the movement of capital or the repatriation of profits, and places few restrictions on foreign ownership. Therefore, the Committee emphasizes that it is recommending Senate approval of the treaty based on its understanding that Hong Kong is excluded from treaty coverage. Inclusion of Hong Kong would render the treaty unacceptable, given the present form of the treaty's anti-treaty shopping rule.

Coordination with tax reform proposals

The Committee is concerned about possible conflicts between the treaty and the Administration's tax reform proposals. In particular, the proposed branch-level tax and dividends paid deduction could conflict with provisions of the treaty.

The United States does not now impose a branch-level tax, but the Administration's May 1985 tax reform proposal asks Congress to enact one. The proposed treaty does not expressly prohibit the United States from imposing a branch-level tax. However, the non-discrimination rule protecting permanent establishments that is found in the proposed treaty and in most U.S. income tax treaties may forbid the imposition of a branch-level-type tax on permanent establishment. The Administration has proposed that any such treaty protection not be overridden by Congress. On enactment, the Administration would instead seek to renegotiate treaties to allow the United States to impose the branch-level tax in particular countries where current treaties prohibit its imposition. The House Committee on Ways and Means (H.R. 3838, H. Rept. No. 99-426, Dec. 7, 1985) has approved a branch-level tax similar to the Administration proposal. That provision would generally defer to existing treaties that prohibit a branch-level tax, except in the case of a treaty-country corporation controlled by residents of a third country.

A similar issue is presented by the Administration's proposal to allow a 10-percent dividends paid deduction to U.S. corporations. The purpose of this deduction is to reduce the burden of the two-tiered taxation of corporate profits under the "classical" system of present law, which imposes a tax at the corporate and shareholder levels. The dividends paid deduction would extend to some dividends paid to foreign shareholders. Absent treaty protection, however, the proposal would impose on such dividends a compensatory withholding tax designed to prevent elimination of all tax on 10 percent of corporate profits where shareholders are not U.S. taxpayers. The proposed treaty with China would prevent U.S. imposition of this compensatory withholding tax. The Administration proposal would not initially impose a compensatory tax on dividends paid to protected treaty country recipients, including Chinese recipients. However, it would delegate to the Secretary of the Treasury the authority to override treaties to impose a compensatory dividend withholding tax on a country-by-country basis. The purpose of this delegation is, in part, to seek similar relief from treaty partner countries. The House Committee on Ways and Means (H.R. 3838) has approved a similar dividends paid deduction and a compensatory withholding tax that would override treaties in certain cases.

Under the Administration tax reform proposal, the Secretary of the Treasury could impose the compensatory withholding tax on a dividend paid to a treaty country recipient if the home country of the recipient indicated an unwillingness to extend its own credit benefits to dividends paid by local companies to U.S. shareholders or if there were treaty shopping concerns. The House Committee on Ways and Means provision (H.R. 3838) would similarly override treaties to impose the compensatory withholding tax if the treaty country continued to deny equivalent- relief (or if the treaty failed to place satisfactory limits on treaty shopping).

The Committee therefore wishes to make it clear that, in recommending Senate approval of the proposed treaty at a time when Congressional efforts to achieve major tax reforms are underway, the Committee expects that Congress' flexibility in the tax reform process will not be restricted by the treaty. The chairmen and ranking minority members of the tax-law writing Committees of the Congress emphasized in letters to this Committee the importance of clarifying that in the context of the reform effort now under way, Congress may find it necessary to exercise its prerogative to override some provisions of treaties, including those recently ratified, that are in conflict with the reforms. Therefore, the Committee wishes to emphasize to our prospective treaty partners that if Congress decides to enact a branch-level tax or dividends paid deduction, Congress may not defer to the contrary provisions of any treaty in doing so.

VII. BUDGET IMPACT

The Committee estimates that the effect of the proposed treaty on budget receipts will be negligible.

In accordance with the objectives of section 403 of the Budget Act, the Committee advises that the Director of the Congressional Budget Office has examined the Committee's budget estimate and agrees that the effect on budget receipts will be negligible. In keeping with the spirit of section 308(a) of the Budget Act, and after consultation with the Director of the of the Congressional Budget Office, the Committee states that the treaty does not provide any new budget authority or any new or increase tax expenditures.

VIII. EXPLANATION OF TREATY PROVISIONS

A detailed article-by-article explanation of the proposed income tax treaty between the United States and the People's Republic of China ("China"), as modified by the proposed protocol, is presented below, followed by separate explanations of the proposed protocol and the notes exchanged when the proposed treaty was signed.

The proposed protocol is unusual in that its signing occurred at the same time as the signing of the proposed treaty. Some of the provisions of the proposed protocol amend specific articles of the proposed treaty, while others do not. The proposed treaty and the proposed protocol, upon entry into force, will operate as one document, and it is of no consequence that some provisions appear in the proposed protocol while others appear in the body of the proposed treaty.

Article 1. (Personal scope)

Article 1 describes the persons who may claim the benefits of the treaty.

The proposed treaty applies to residents of the United States and to residents of China. Specific exceptions are designated in other articles and in the proposed protocol. This application follows other U.S. income tax treaties, the U.S. model treaty, and the OECD model treaty. The treaty also applies, in limited cases designated in other articles, to persons who are residents of neither China nor the United States. Article 4 defines the term "resident".

Article 2. (Taxes covered)

In general, in the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Internal Revenue Code (the "Code").

The proposed protocol provides that the United States may, with one exception, impose its personal holding company and accumulated earnings taxes notwithstanding the treaty; the protocol exempts Chinese companies from these two taxes if they are wholly owned, directly or indirectly, by the Chinese Government (or any wholly owned agency thereof) or one or more individual Chinese residents (who are not U.S. citizens). The proposed protocol also provides that the United States may impose its social security tax notwithstanding the treaty.

Because the proposed treaty applies to the Federal income taxes only, it does not cover the U.S. excise tax on insurance premiums imposed under section 4371 of the Code. Accordingly, the United States may impose this tax without restriction.

In the case of China, the proposed treaty applies to the individual income tax, the income tax concerning joint ventures with Chinese and foreign investment, the income tax concerning foreign enterprises, and the local income tax.

The proposed treaty also contains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar taxes that either country may subsequently impose.

The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country, within an appropriate time period, of any substantial changes in the tax laws of its country.

Article 3. (General definitions)

The proposed treaty contains certain of the standard definitions found in most U.S. income tax treaties.

The term "the People's Republic of China" means all of the territory of the People's Republic of China, including its territorial sea, in which China's internal tax laws are in force. The term also includes all the area beyond China's territorial sea, including the sea-bed and subsoil, over which China has jurisdiction in accordance with international law and in which China's internal tax laws are in force. Therefore, income earned on the Chinese continental shelf is covered.

The Chinese Government has consistently taken the view that Hong Kong is Chinese territory. However, the New Territories of Hong Kong (comprising 92 percent of the total land area of Hong Kong) have been leased to Britain since 1898 under a 99-year lease and the remaining portions of Hong Kong were ceded in perpetuity to Britain earlier in the 19th Century. China has announced its intention to resume the exercise of sovereignty over all of Hong Kong upon the expiration of the 99-year lease in 1997 and has concluded an agreement with Britain governing that resumption of sovereign control (the Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Future of Hong Kong, hereinafter referred to as the "Hong Kong Agreement"). The proposed treaty does not address directly the question of whether it will cover Hong Kong once Chinese sovereignty is resumed. However, based on the terms of the Hong Kong Agreement as they relate to the treaty definition of China, the Committee concludes that the treaty will not apply to Hong Kong, and recommends approval of the treaty on that basis.

Under the Hong Kong Agreement, China will establish a Hong Kong Special Administrative Region upon resuming the exercise of sovereignty over Hong Kong. The Hong Kong Special Administrative Region will be directly under the authority of the Central People's Government of China. However, the Hong Kong Special Administrative Region will enjoy a high degree of autonomy, except in foreign and defense affairs, and will be vested with executive, legislative, and independent judicial power under the terms of the Hong Kong Agreement. The laws currently in force in Hong Kong will remain basically unchanged for 50 years. The Hong Kong Special Administrative Region will have independent finances and the Central People's Government will not levy taxes in it. Thus, China's internal tax laws will not be "in force" in Hong Kong even after sovereign control is resumed under the terms of the Hong Kong Agreement for a 50-year period. As a result, Hong Kong will not be considered part of China for treaty purposes under the treaty definition of China.

The exclusion of Hong Kong from treaty coverage is important because treaty coverage could create opportunities for third-country residents to use a Hong Kong entity to obtain the treaty reductions in U.S. tax: as indicated in the discussion of treaty shopping issues above, the anti-treaty shopping provisions of the proposed treaty are very limited and Hong Kong has low tax rates and other tax and non-tax rules that make it highly attractive to foreign investors.

The proposed treaty defines "the United States" to mean all of the territory of the United States of America, including its territorial sea, in which the United States' internal tax laws are in force. The term also includes all the area beyond the United States' territorial sea, including the sea-bed and subsoil, over which the United States has jurisdiction in accordance with international law and in which the United States' internal tax laws are in force. This definition of the United States differs somewhat in form from the U.S. model definition but its meaning is intended to be the same. The definition is intended to cover the U.S. continental shelf consistent with the definition of continental shelf contained in section 638 of the Code.

The term "Contracting State" means the People's Republic of China or the United States, as the context requires.

The term "tax" means the covered Chinese taxes or the covered U.S. taxes, as the context requires.

The term "person" is defined to include an individual, a company, a partnership, and any other body of persons. The proposed protocol provides that the term also includes an estate or a trust. A "company" is any body corporate or any other entity which is treated as a body corporate for tax purposes.

An enterprise of a country is defined as an enterprise carried on by a resident of that country. Although the treaty does not define the term "enterprise," it will have the same meaning that it has in other U.S. tax treaties—the trade or business activities undertaken by an individual, company, partnership, or other entity.

The term "nationals" means all individuals having U.S. or Chinese nationality and all legal persons, partnerships, and other bodies of persons deriving their status as such from the laws in force in the United States or China.

The U.S. competent authority is the Secretary of the Treasury or his authorized representative. In fact, the U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has redelegated the authority to the Associate Commissioner (Operations). The Assistant Commissioner (Examination) has been delegated the authority to administer programs for simultaneous, spontaneous, and industry-wide exchanges of information. The Director, Foreign Operations District, has been delegated the authority to administer programs for routine and specific exchanges of information and mutual assistance in collection.

The Chinese competent authority is the Ministry of Finance, or its authorized representative.

The treaty provides that any term not defined in the treaty is to have the meaning it has under the applicable tax laws of the country applying the treaty, unless the context requires otherwise. This provision differs from the standard U.S. treaty provision, which authorizes the two countries, in addition, to establish a common meaning for an undefined term by mutual agreement. It is the view of the Committee (as well as the countries' negotiators), however, that the countries are authorized under the mutual agreement article (Article 24) to establish a common meaning for an undefined term, this variation in treaty language notwithstanding.

Article 4. (Fiscal residence)

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the countries as that term is defined in the treaty. Furthermore, double taxation is often avoided by the treaty assigning one of the countries as the country of residence where, under the laws of the countries, a person is a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his worldwide income, while a nonresident alien is taxed only on U.S. source income and on his income that is effectively connected with a U.S. trade or business. Under the standards for determining residence provided in the Tax Reform Act of 1984 (which were generally effective on January 1, 1985), an individual who spends substantial time in the United States in any year or over a three-year period generally is a U.S. resident. A permanent resident for immigration purposes also is a U.S. resident. The standards for determining residence provided in the 1984 Act do not apply in determining residence of a U.S. citizen for the purpose of any U.S. tax treaty (such as a treaty that benefits residents, rather than citizens, of the United States). A company is a resident of the United States if it is organized in the United States.

Under the proposed treaty, a person (either an individual or an entity such as a corporation or a partnership) is considered to be a resident of a country if, under the laws of that country, the person is liable to taxation by that country because it is his country of domicile, residence, place of head office, place of incorporation, or by reason of other criteria of a similar nature.

This provision of the proposed treaty is generally based on the fiscal domicile article of the U.S. and OECD model treaties and is similar to the provisions found in other U.S. tax treaties. However, the provision differs in certain respects from those found in the other treaties. For example, it does not explicitly exclude from treaty coverage persons who are taxable in one of the countries only with respect to income from sources in that country or capital situated in that country. Despite this omission, the Committee intends that third-country residents liable to tax in China or the United States only with respect to income from sources in (or capital situated in) China or the United States will not be eligible for benefits under the treaty.

Consistent with most U.S. income tax treaties, citizenship alone does not establish residence. As a result, U.S. citizens residing over-seas are not entitled to the benefits of the treaty as U.S. residents. This result is contrary to U.S. treaty policy as expressed in the U.S. model, but the U.S. model result has been achieved in very few treaties.

In the case of a dual resident individual, residence for treaty purposes is to be determined by the competent authorities of the two countries through consultations. In determining the treaty residence of a dual residence individual, the competent authorities are, under the protocol, to be guided by the "tie-breaker" rules contained in the corresponding article of the United Nations model treaty. Under these rules, if one criterion does not determine a single residence, the second criterion comes into consideration, and so on. The tie-breaker rules of the United Nations model treaty are identical to those of the U.S. model treaty. However, the U.S. model treaty and most recent U.S. income tax treaties differ from the proposed treaty in permitting the application of the tie-breaker rules by one country without consultation with the competent authority of the other country. Resolution of an issue under the competent authority mechanism may take a substantial amount of time.

In the case of a dual resident company, residence for treaty purposes, again, is to be determined by the competent authorities of the two countries through consultations. If the competent authorities are unable to reach a determination, the company will not be considered a resident of either country under the treaty. This rule differs from that of the U.S. model, but is contained in several other U.S. tax treaties. Under the U.S. model, a dual resident company that is created under the laws of one of the countries is deemed a resident of that country for treaty purposes.

A company that is both a U.S. resident under the general rule of this article and a resident of a third country under a tax agreement between that third country and China will not be considered a U.S. resident for purposes of enjoying the benefits of the proposed treaty. This rule could disqualify the U.S.-incorporated companies doing business in China that are considered to be managed in, and therefore, residents of, other Chinese treaty partners, from the reductions in Chinese tax provided by the proposed treaty. Such companies could, however, be entitled to the Chinese tax benefits granted by the other agreement. This rule is not contained in the U.S. model or in recent U.S. income tax treaties.

Article 5. (Permanent establishment)

The proposed treaty contains a definition of the term "permanent establishment" that, with certain exceptions, follows the pattern of other recent U.S. income tax treaties, the U.S. model and the OECD model. Certain aspects of the definition are modeled after the permanent establishment definition of the United Nations model treaty.

The permanent establishment concept is one of the basic devices used in income tax treaties to avoid double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties will apply, or whether those amounts will be taxed as business profits. U.S. taxation of business profits is discussed under Article 7.

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which a resident of one country engages in business in the other country. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry, or other place of extraction of natural resources.

A permanent establishment also includes any building site, construction, assembly, or installation project, or supervisory activities performed in connection therewith, if the site, project, or activities continue for a period of more than six months. This provision is modeled upon the corresponding provision of the United Nations model treaty. The U.S. model treaty contains a somewhat similar provision. However, the U.S. model provision utilizes a twelve-month rule rather than a six-month rule. Also, the U.S. model treaty does not treat supervisory activities performed in connection with a building site, etc., by themselves, as a permanent establishment.

An installation, drilling rig, or ship used for the exploration or exploitation of natural resources will constitute a permanent establishment if it is used for those purposes in one of the countries (as they are defined in the treaty) for a period of more than three months. This three-month rule differs from the twelve-month rule of the U.S. model treaty.

The furnishing of services by an enterprise, including consultancy services, through employees or other personnel engaged by the enterprise for that purpose will give rise to a permanent establishment if the activities continued (for the same or a connected project) within a country for a period or periods aggregating more than six months within any twelve-month period. This provision, which does not require a fixed place of business for there to be a permanent establishment, is similar to one included in the United Nations model treaty. It is not found in the U.S. model treaty but has been included, in roughly similar form, in some recent U.S. income tax treaties with developing countries (e.g., Jamaica and the Philippines).

The general permanent establishment rule is modified to provide that a fixed place of business that is used for any of a number of specified activities will not constitute a permanent establishment. These activities include the use of facilities solely for storing, displaying, or delivering merchandise belonging to the enterprise and the maintenance of a stock of goods belonging to the enterprise solely for storage, display, or delivery, or solely for processing by another enterprise. These activities also include the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information, or solely for the purpose of carrying on, for the enterprise, any other preparatory or auxiliary activity. Under the proposed treaty, a fixed place of business used solely for any combination of the above-mentioned activities will not constitute a permanent establishment provided that the overall activity of the fixed place of business is of a preparatory or auxiliary character.

If a person has, and habitually exercises, the authority to conclude contracts in a country on behalf of an enterprise of the other country, then the enterprise will be deemed to have a permanent establishment in the first country. This rule does not apply where the contracting authority is limited to those activities, such as storage, display, or delivery of merchandise (described above), that are excluded from the definition of permanent establishment. The proposed treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent, or other agent of independent status acting in the ordinary course of its business. However, the proposed treaty adds the limitation that, when the activities of an agent are devoted wholly or almost wholly on behalf of one enterprise, the agent will not be considered an independent agent if the transactions between it and that enterprise were not made under arm's-length conditions.

The determination whether a company of one country has a permanent establishment in the other country is to be made without regard to the fact that the company may be related to a company that is a resident of the other country or to a company that engages in business in that other country. Any such relationship is thus not relevant; only the activities of the company being tested are relevant.

Article 6. (Income from real property)

This article covers income from real property. The rules governing gains from the sale of real property are in Article 12.

Under the proposed treaty, income derived by a resident of one country from real property situated in the other country may be taxed in the country where the real property is located.

The term "real property" has the meaning which it has under the law of the country in which the property in question is situated. The term in any case includes property accessory to real property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of real property, and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Thus, income from real property will include royalties and other payments in respect of the exploitation of natural resources (e.g., oil). It does not include interest on loans secured by real property. Ships and aircraft are not real property.

The source country may tax income derived from the direct use, letting, or use in any other form of real property. These rules allowing source country taxation also apply to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

The U.S. model treaty and certain other U.S. income tax treaties permit a resident of one country to elect to be taxed on a net basis by the other country on income from real property in that other country. The proposed treaty does not contain that election, but such an election is provided for U.S. real property income under the Code (secs. 871(d) and 882(d)).

Article 7. (Business profits)

U.S. Code rules

U.S. law distinguishes between the business income and the investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30 percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income varies depending upon whether the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or businesses were a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected income.

Foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. Only three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends, interest, or gain from stock or debt derived in the active conduct of a banking, financing or similar business in the United States; and certain sales income attributable to a U.S. sales office.

Except in the case of a dealer, trading in stocks, securities, or commodities in the United States for one's own account does not constitute a trade or business in the United States and accordingly income from those activities is not taxed by the United States as business income. This concept includes trading through a U.S.-based employee, a resident broker, commission agent, custodian, or other agent or trading by a foreign person physically present in the United State.

Proposed treaty rules

Under the proposed treaty, business profits of an enterprise of one country are taxable in the other country only to the extent they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This is one of the basic limitations on a country's right to tax income of a resident of the other country.

The taxation of business profits under the proposed treaty differs from U.S. rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits, and by substituting an "attributable to" standard for the Code's "effectively connected" standard. Under the Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the proposed treaty, on the other hand, some level of fixed place of business must be present and the business profits must be attributable to that fixed place of business.

Unlike many U.S. treaties and the U.S. model treaty, the proposed treaty does not define the term "business profits." To the extent not dealt with in other articles, the term either will be defined under the law of the country applying the treaty or by mutual agreement of the two countries. The proposed treaty would thus leave it to Chinese law, for example, to determine whether an item of income not dealt with elsewhere in the treaty that is earned by a U.S. company through a permanent establishment in China constitutes business profits and, therefore, is taxable by China under this treaty article.

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there is to be attributed to a permanent establishment the business profits that would reasonably be expected to have been derived by it if it were a distinct and independent entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment. For example, this arm's-length rule applies to transactions between a permanent establishment and an office of the resident enterprise located in a third-country. Amounts may be attributed whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits, deductions generally are allowed for expenses, wherever incurred, that are incurred for the purposes of the permanent establishment. These deductions include executive and general administrative expenses. However, no deduction will be allowed for amounts paid (other than in reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or to any of its other offices, by way of royalties or other similar payments or by way of interest on money lent to the permanent establishment. Similarly, no account will be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or to any of its other offices, by way of royalties or other similar payments or by way of interest on money lent to the head office of the enterprise or to any of its other offices. These rules limiting deductions, which are not found in the U.S. or OECD model treaty, are patterned after rules contained in the United Nations model treaty. Similar rules are contained in certain other U.S. income tax treaties with developing countries. The same result would, in general, be reached under the U.S. model treaty and other U.S. tax treaties not containing such specific language.

The treaty expressly reserves to each country the right to determine taxable profits in a specific industry on a deemed basis where the country's internal law provides for the determination of taxable profits in that industry on a deemed basis and the result is in accordance with the principles of this article. The Committee understands that it is generally China's practice to deem as taxable profits 10 percent of the Chinese source gross receipts of U.S. subcontractors from offshore oil operations. The Committee also understands that China deems as taxable profits 10 percent of the Chinese source gross receipts with respect to outgoing traffic received by operators of ships and aircraft in international traffic. In both cases, a 50-percent tax is imposed on the deemed profits. Thus, the treaty, for example, will permit China to collect a tax from a U.S. oil driller equal to five percent of the gross receipts, if any, attributable to a drilling rig of the driller that is situated in, and remains for more than three months in, the South China Sea, provided this tax is in accordance with the principles of this article. Under the agreement currently in force between the United States and China governing the taxation of shipping and aircraft income, income earned by a U.S. enterprise from the operation of ships or aircraft in international traffic is exempt from Chinese tax. The U.S. model treaty does not reserve to a country the right to determine profits on a deemed basis.

Business profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by the permanent establishment for the account of the enterprise. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element in its purchasing activities. The amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good and sufficient reason to change the method.

Where business profits include items of income that are dealt with separately in other articles of the treaty, those other articles, and not this business profits article, generally will govern the treatment of those items of income. Thus, for example, dividends generally are taxed under the provisions of Article 9 and not as business profits.

Article 8. (Related persons)

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision similar to section 482 of the Code that recognizes the right of each country to make an allocation of income to that country in the case of transactions between related enterprises, if an allocation is necessary to reflect the conditions and arrangements that would have been made between independent enterprises.

For purposes of the proposed treaty an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control, or capital of the other enterprise. The enterprises are also related if the same persons participate directly or indirectly in the management, control, or capital of both enterprises.

When a redetermination of tax liability has been properly made by one country, the other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making that adjustment, due regard is to be paid to other provisions of the treaty and the competent authorities of the two countries will consult with each other if necessary.

The proposed treaty omits the usual provision stating that this article is not intended to limit any law in either country which permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between non-independent persons when such law is necessary to prevent evasion of taxes or to reflect clearly the income of those persons. That provision makes it clear that the United States retains the right to apply its inter-company pricing rules (Code sec. 482) and its rules relating to the allocation of deductions (Code secs. 861, 862, and 863, and Treas. Reg. sec. 1.861-8). Notwithstanding the omission of this provision, the Committee understands that the United States retains the right under the proposed treaty to apply its inter-company pricing and deduction allocation rules, and recommends approval of the treaty on that basis.

Article 9. (Dividends)

The United States imposes a 30-percent withholding tax on the gross amount of U.S. source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax like a U.S. person at the standard graduated rates, on a net basis. U.S. source dividends, for purposes of the 30-percent tax, are dividends paid by a U.S. corporation (other than an "80/20 company" described in Code sec. 861(a)(2)(A)). Also treated as U.S. source dividends for this purpose are certain dividends paid by a foreign corporation, if at least 50 percent of the gross income of the foreign corporation, in the prior three-year period, was effectively connected with a U.S. trade or business of that foreign corporation. The tax imposed on the latter dividends is often referred to as the "second tier" withholding tax.

Under the proposed treaty, each country may tax dividends paid by its resident companies but the tax is generally limited to 10 percent of the gross amount of the dividends if the recipient of the dividends is a resident of the other country and is the beneficial owner of the dividends. This rule does not restrict the right of a country to tax the profits out of which dividends are paid. Under the U.S. model, source country tax is limited to five percent on dividends paid to "direct" investors (i.e., companies which own at least 10 percent of the voting stock of the company paying the dividends) and to 15 percent on dividends paid to "portfolio" investors (i.e., investors other than direct investors).

Like the U.S. model treaty, the proposed treaty defines "dividends" as income from shares or other rights which participate in profits and which are not debt claims. Dividends also include income from other corporate rights which is subjected to the same tax treatment by the country in which the distributing corporation is resident as income from shares. Under this provision, each country may apply its rules for determining when a payment by a resident company is on a debt obligation or an equity interest.

The treaty limitation on source country dividend tax will not apply if the beneficial owner of the dividend has a permanent establishment (or fixed base in the case of an individual performing independent personal services) in the source country and the shareholding or other corporate right with respect to which the dividends are paid is effectively connected with the permanent establishment (or fixed base). Dividends paid on shareholdings or other corporate rights effectively connected with a permanent establishment are to be taxed as business profits (Article 7). Dividends paid on shareholdings or other corporate rights effectively connected with a fixed base are to be taxed as income from independent personal services (Article 13).

The proposed treaty limits the right of a country to tax dividends paid by a company resident in the other country that derives profits or income in the first country. The country in which the company is not resident may tax dividends paid by the company only if they are paid to a resident of that country or if the shareholding or other corporate rights with respect to which the dividends are paid are effectively connected with a permanent establishment or fixed base maintained in that country. Unlike the U.S. model treaty, the proposed treaty does not allow one country to tax dividends paid by a resident company of the other country on the basis that the dividends are from gross income of its permanent establishment in the first country constituting 50 percent or more of its worldwide income. The effect of this departure from the U.S. model is to waive the United States' second tier witholding tax on dividends paid by Chinese companies earning 50 percent or more of their income from U.S. business. This provision follows the OECD and United Nations model treaties.

The proposed treaty also exempts the undistributed profits of a company resident in one country that derives profits or income in the other country from the second country's tax on undistributed profits. The exemption applies even if the undistributed profits consist wholly or partly of profits or income arising in the second country. The U.S. model treaty does not include the specific exemption; the OECD and United Nations model treaties do.

Article 10. (Interest)

In general, the United States imposes a 30-percent tax on U.S. source interest paid to foreign persons under the same rules that apply to dividends. However, the Tax Reform Act of 1984 repealed the tax for interest paid on certain portfolio indebtedness to nonresident alien individuals and foreign corporations. (This change was effective for interest paid on portfolio indebtedness issued after July 18, 1984, the date of enactment of the 1984 Act.) U.S. source interest, for purposes of the 30-percent tax, generally is interest on debt obligations of U.S. persons, but not interest on deposits in banks. U.S. source interest for this purpose also includes interest paid by a foreign corporation if at least 50 percent of the gross income of the foreign corporation, in the prior three-year period, was effectively connected with a U.S. trade or business of that corporation. The tax imposed on the latter interest is often referred to as the "second tier" withholding tax.

Under the proposed treaty, each country may tax interest arising within that country, but the tax is generally limited to 10 percent of the gross amount of the interest if its recipient is a resident of the other country and is the beneficial owner of the interest. This limitation on source country tax does not apply if the recipient of the interest is a nominee for a nonresident (see Part III for a discussion of this rule). (The protocol provides additional rules intended to prevent treaty shopping.) The 10-percent limitation contrasts with the U.S. model position, not generally achieved, that interest generally should be exempt from tax at source.

In certain cases, interest will be exempt from tax at source under the proposed treaty. These are where the interest is derived by the government of the other country, or a political subdivision or local authority in that other country; the interest is derived by the Central Bank of the other country; the interest is derived by any financial institution wholly owned by the government of the other country; or the interest is derived by any resident of the other country with respect to debt-claims indirectly financed by any of the entities just described. The effect of this treatment will be to exempt certain interest paid to Chinese recipients from U.S. tax without a general reciprocal exemption.

Neither the 10 percent limitation nor the exemptions will apply if the beneficial owner of the interest has a permanent establishment or fixed base in the source country and the debt-claim is effectively connected with the permanent establishment or fixed base. In the event, the interest will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 13).

The proposed treaty provides source rules for interest. Interest generally will be considered to arise within a country if the payor is the government of that country, including political subdivisions and local authorities, or a resident of that country. Generally, this rule is consistent with U.S. source rules which provide that interest (other than certain interest paid by foreign corporation) is sourced in the country in which the payor is resident. The treaty also provides, however, that if interest is borne by a permanent establishment (or fixed base) that the payor has in one of the countries and the indebtedness was incurred with respect to that permanent establishment (or fixed base), the then interest will be sourced in that country, regardless of the residence of the payor.

These source rules effectively prohibit one country from taxing interest paid by a resident company of the other country on the basis that the interest is from profits of its permanent establishment in the first country constituting 50 percent or more of its worldwide income. The effect of this departure from the U.S. model is to waive the United States' second tier withholding tax on interest paid by foreign companies earning 50 percent or more of their income from U.S. business.

The proposed treaty addresses the issue of non-arm's-length interest charges between related parties (or parties having an otherwise special relationship) by holding that the amount of interest for purposes of applying this article will be the amount of arm's-length interest. Any amount of interest paid in excess of the arm's-length interest, for whatever reason, will be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess interest paid to a parent corporation may be treated as a dividend under local law and thus be entitled to the benefits of Article 9 of the proposed treaty.

The proposed treaty defines "interest" as income from debt-claims of every kind, whether or not secured and whether or not carrying a right to participate in profits. In particular, it includes income from government securities and from bonds or debentures, including premiums or prizes attaching to bonds or debentures.

Article 11. (Royalties)

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax on U.S. source royalties paid to foreign persons. Royalties are from U.S. sources if they are for the use of property located in the United States. U.S. source royalties include royalties for the use of or the right to use intangibles in the United States. Such royalties include motion picture royalties.

Under the proposed treaty. each country may tax royalties arising within that country, but the tax is generally limited to 10 percent of the gross amount of the royalties if their recipient is a resident of the other country and is the beneficial owner of the royalties. In the case of royalties paid for the rental of industrial, commercial, or scientific equipment, the proposed protocol provides that source country tax may be imposed on 70 percent of the gross amount of the royalties only. This protocol provision effectively limits to seven percent the maximum source country tax on these types of royalties. The U.S. model treaty exempts royalties from tax at source.

The 10- and seven-percent tax limitations will not apply if the recipient of the royalty is a nominee for a nonresident (see introductory material for a discussion of this rule). They also will not apply if the recipient is an enterprise with a permanent establishment in the source country or an individual performing personal services in an independent capacity through a fixed base in the source country, and the property giving rise to the royalty is effectively connected with the permanent establishment or fixed base. In that event, the royalties will be taxed as business profits (Article 7) or as income from the performance of independent personal services (Article 13).

The proposed treaty defines "royalties" as payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work including cinematographic films, films or tapes used for radio or television broadcasting, any patent, technical know-how, trade mark, design or model, plan, secret formula, or process. Royalties are also payments of any kind received as consideration for the use of or the right to use industrial, commercial, or scientific equipment, or for information concerning such equipment. The treaty's royalty definition follows that the OECD and United Nations models.

The proposed treaty provides special source rules for royalties that differ somewhat from the U.S. source rules for royalties. Generally, as indicated above, under U.S. tax rules (Code secs. 861-62), royalty income is sourced where the property or right is being used. Under the proposed treaty, if a royalty is paid by the government of one of the countries, including political subdivisions and local authorities, or by a resident of one of the countries, then the royalty generally will be sourced in the country of residence of the payor. However, if the payor has a permanent establishment or fixed base in one of the countries in connection with which the obligation to pay the royalty was incurred, and if the royalty is borne by that permanent establishment or fixed base, then the royalty arises in the country in which the permanent establishment or fixed base is situated. If these rules do not result in the sourcing of the royalty in the United States or China, and if the royalty relates to the use of or the right to use the right or property in one of the two countries, then the royalty is treated as arising in that country.

The treaty source rules for royalties derive primarily from notes accompanying the United Nations model treaty. The U.S.-New Zealand income tax treaty, ratified in 1983, contains similar source rules for royalties.

The proposed protocol addresses the issue of non-arm's-length royalties between related parties (or parties having an otherwise special relationship) by holding that the amount of royalties for purposes of applying this article will be the amount of arm's-length royalties. Any amount of royalties paid in excess of the arm's-length royalty will be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess royalties paid to a parent corporation may be treated as a dividend under local law and thus be entitled to the benefits of Article 9 of the proposed treaty.

Article 12. (Gains)

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he or she is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended ("FIRPTA"), a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interest" include interests in certain corporations holding U.S. real property.

Under the proposed treaty, gains from the disposition of movable (personal) property that forms part of the business property of a permanent establishment that an enterprise of one country has or had in the other country, or gains from the alienation of movable (personal) property pertaining to a fixed base available to a resident of one country in the other country for the purpose of performing independent personal services, including gains from the disposition of such a permanent establishment (alone or together with the whole enterprise) or of such a fixed base, may be taxed in that other country.

Gains derived by a resident of one country from, the disposition of ships or aircraft operated in international traffic, and from the disposition of movable (personal) property pertaining to the operation of such ships or aircraft are taxable only in that country.

Gains from the disposition of real property may be taxed in the country where the real property is situated. Real property for this purpose is defined as it is under the article governing taxation of income from real property (Article 6). In addition, gains frm the dispositon of shares of the capital stock of a company whose property consists (directly or indirectly) principally of real property situated in a country may be taxed in the situs country. Unlike the U.S., OECD, and United Nations model treaties, the proposed treaty provides that gains arising in one country from the disposition by a resident of the other country of any property not referred to elsewhere in the gains article may be taxed in the first country. Taken together, these rules are intended to allow the United States to tax any transaction of a Chinese resident otherwise taxable under FIRPTA. While the treaty definition of real property under Article 6 may not encompass all "U.S. real property interests" whose disposition is taxable under FIRPTA, assigning the source country a right to tax any property gains not referred to elsewhere in the article safeguards the U.S. tax. The latter rule is understood to allow the United States to tax, among other real property gains, gains from the disposition of interests in partnerships, trusts, and estates to the extent attributable to U.S. real property interests, since such gains are considered under FIRPTA to be deried from the disposition in the United States of such property. (See Code sec. 897(g).)

Gains from the disposition of shares (other than shares in a company whose property is principally real property, as discussed above) representing a 25-percent (or greater) participation in a company resident in a country may be taxed in that country. This provision is taken from the United Nations model treaty; neither the U.S. model nor the OECD model includes it.

Article 13. (Independent personal services)

The United States taxes the income of a nonresident alien at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 7.) The performance of personal services within the United States can be a trade or business within the United States (Code sec. 864(b)).

The proposed treaty limits the right of a country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty, income from the performance of independent personal services is treated separately from salaries, wages, and similar remuneration received by employees.

Under the proposed treaty, income derived by an individual resident in one country from professional services or other activities of an independent character may be taxed in the other country in two cases only. The nonresident country may tax the income if the individual has a fixed base regularly available to him or her in the nonresident country for the purpose of performing his or her activities. Only that portion of the individual's income attributable to the fixed base may be taxed in the nonresident country. The nonresident country also may tax the individual's independent personal services income if the individual is present in the nonresident country for more than 183 days during the calendar year concerned. In that case, only that portion of the individual's income derived in the nonresident country while the individual was present there may be taxed in the nonresident country.

This partial exemption from tax parallels that provided for independent personal services income under the United Nations model treaty. The U.S. model treaty provides a broader tax exemption for such income: the U.S. model does not contain a 183-day rule; it allows taxation in the nonresident country only on the basis of a fixed base regularly available there to the individaul performing the independent personal services.

The term "professional services" includes independent scientific, literary, artistic, educational, and teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and acccountants.

Article 14. (Dependent personal services)

Under the Code, the income of a nonresident alien from the performance of personal services in the United States is not taxed if the individual is not in the United States for at least 90 days during a taxable year, the compensation does not exceed $3,000, and the services are performed as an employee of a foreign person not engaged in a trade or business in the United States or they are performed for a foreign office or place of business of a U.S. person.

Under the proposed treaty, income from services performed as an employee in one country (the source country) by a resident of the other country will be taxable only in the residence country if three requirements are met: (1) the recipient is present in the source country for fewer than 184 days during the calendar year concerned; (2) the employer of the recipient is not a resident of the source country; and (33) the compensation is not borne by a permanent establishment or fixed base of the employer in th source country. Under the U.S. model, the fewer-than-184-day-test is computed on the basis of the tax year, not on the basis of the calendar year. However, because most individual U.S. taxpayers use the calendar year as their tax year, this dpeparture from the U.S. model is of little significance.

This article is modified in some respects for directors' fees (Article 15), pensions (article 17), compensation of government employees (Article 18), remuneration for teaching, lectures, and research (Article 19), and income of students, business apprentices, and trainees (Article 20). In addition, income derived as an entertainer or athlete is taxed in accordance with special rules (Article 16).

Article 15. (Directors' fees)

Under the proposed treaty, directors' fees and similar payments derived by a resident of one country in his or her capacity as a member of the board of directors of a company that is a resident of the other country may be taxed in that other country.

This rule for directors' fees follows the OECD model. It differs from the rule of the U.S. model treaty. The U.S. model treats directors' fees as personal services income or distributed profits, primary taxing jurisdiction over which generally belongs to the country where the recipient resides.

Article 16. (Entertainers and atheletes)

The proposed treaty contains a separate set of rules that apply to the taxation of income earned by entertainers (such as theater, motion picture, radio, or television "artistes" or musicians) and athletes. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 13 adnd 14), and are intended, in part, to prevent entertainers and athletes from using the treaty to avoid paying any tax on their income earned in one of the countries.

Under the proposed treaty, income derived by entertainers and athletes resident in one country from their personal activities as such exercised in the other country generally may be taxed in that other country. However, such income will be exempt from tax in the source country if the personal activities are exercised in accordance with a special program for cultural exchange agreed upon by the governments of the United States and China. This exemption from source country taxation differs from that provided by the U.S. model treaty and most U.S. income tax treaties for entertainers' and athletes' income. Under the U.S. model treaty, entertainers' and athletes' income from their activities as such is exempt from tax in the source country if the gross receipts from those activities derived in the source country are $20,000 or less for the year. (The dollar amount is lower in most U.S. income tax treaties). There is no separate rule in the U.S. model for income derived in connection with participation in a cultural exchange program.

The Committee is informed that U.S. entertainers and athletes presently perform in China (and Chinese entertainers and athletes presently perform in the United States) only in accordance with cultural exchange programs approved by the two countries. So long as this practice continues, the proposed treaty rule, as a practical matter, will exempt entertainers' and athletes' income from tax at source.

The proposed treaty provides that where income in respect of personal activities performed by an entertainer or athlete in his capacity as such accrues not to the entertainer or athlete, but to another person, that income may be taxed by the country in which the activities are exercised. (This provision applies notwithstanding the business profits and personal services articles (Articles 7, 13 and 14). This provision is intended to prevent highly paid performers and athletes from avoiding tax in the country in which they perform by routing the compensation for their services through a third person such as a personal holding company or a trust located in a country that would not tax the income. The provision does not apply to income otherwise exempt from source country taxation under this article (i.e., income derived by an entertainer or athlete in connection with participation in a special program for cultural exchange). The corresponding provision of the U.S. model treaty, by contrast, does apply to income that would otherwise be exempt from source country taxation under this article.

Article 17. (Pensions)

Under the proposed treaty, pensions and other similar remuneration paid to a resident of either country in consideration of past employment generally are subject to tax only in the recipient's country of residence.

The above rule does not apply to pension paid to a resident of one country attributable to services performed for governmental entities of the other unless the recipient is also a national of the first country (see Article 18). The general rule also does not apply to pensions and other payments from the government or a political subdivision or local authority of a country under its social security system or public welfare plan; such pensions and other payments may be taxed in that country only. For example, only the United States may tax U.S. social security payments to U.S. persons residing in China. The article thus safeguards the Untied States' right under the Social Security Amendments of 1983 to tax a portion of U.S. social security benefits received by nonresident individuals, while protecting any such individuals residing in China from double taxation.

The corresponding article of the U.S. model treaty contains rules for annuities, alimony payments, and child support payments that the proposed treaty does not contain. Under the U.S. model treaty, annuities and alimony payments (and other maintenance payments other than child support payments) are taxable only by the country of residence of the recipient, while child support payments are taxable only by the country of the payor. The child support rule in the U.S. model is not subject to the saving clause. Under the proposed treaty, annuities, alimony payments, and child support payments are covered under Article 21: under that aritcle, they may be taxed in both the country of residence of the recipient and the country where they arise.

Article 18. (Government service)

The proposed treaty generally exempts the wages of employees of one of the countries from tax in the other country.

Under the proposed treaty, remuneration, other than a pension, paid by the government of a country or one of the country's political subdivisions or local authorities to an individual for services rendered to the government (or subdivision or authority) generally will be taxable in that country only. However, such remuneration will be taxable only in the other country (the country not the payor) if the services are rendered in that other country and the individual is a resident of that other country who either (1) is a national of that country or (2) did not become a resident of that country solely for the purpose of rendering the services. Thus, for example, China would not tax the compensation of a U.S. national and resident who is in China to perform services for the U.S. Government. The United States would not tax the compensation of a Chinese national and resident who performs services for the U.S. Government in China.

Any pension paid by, or out of funds created by, the government of a country or one of the country's political subdivisions or local authorities to an individual for services rendered to the government (or subdivision or authority) generally will be taxable only in that country. However, such a pension will be taxable only in the other country if the individual is both a resident and a national of that other country.

The above rules follow those of the OECD and United Nations model treaties. In the situations described above, the U.S. model treaty assigns exclusive taxing jurisdiction to the paying country, but only in the case of payments to one of its citizens.

If the government of a country or one of the country's political subdivisions or local authorities is carrying on a business (as opposed to functions of a governmental nature), the provisions of Articles 14, 15, 16, and 17 will apply to remuneration and pensions for services rendered in connection with that business.

The saving clause (discussed under the proposed protocol below) overrides this article in the case of U.S. citizens, but not in the case of U.S. residents who are not U.S. citizens.

Article 19. (Teachers and researchers)

An individual temporarily present in one country for the primary purpose of teaching, giving lectures, or conducting research at a university, college, school, or other accredited educational institution or scientific research institution in that country will be exempt from tax in that country for three years on remuneration for the teaching, lecturing, or research if he or she is a resident of the other country or was such a resident immediately before visiting the host country. Under this provision, a U.S. professor, for example, who visits China for nine months for the primary purpose of teaching at a Chinese university will be exempt from Chinese tax on remuneration the professor receives for the teaching. However, the professor may be taxed by China under the 183-day-presence-rule of Article 13 on any other independent personal services income (e.g., income from consulting) that the professor may earn while in China.

A number of U.S. income tax treaties provide a similar exemption for visiting teachers and researchers. However, the exemption provided in other U.S. treaties typically is for two years, not three. Unlike the proposed treaty, some U.S. treaties expressly limit the exemption, in the case of income from research, to income from research undertaken in the public interest rather than primarily for private benefit. Treasury's Technical Explanation states that this limitation is understood to apply in this treaty as well.

The U.S., OECD, and United Nations model treaties do not contain a special exemption for visiting teachers and researchers.

Article 20. (Students, apprentices, and trainees)

A student, business apprentice, or trainee who is present in one of the countries solely for the purrpose of his or her education or training or obtaining special technical experience will be exempt from tax in that country with respect to certain income if he or she is a resident of the other country, or was such a resident immediately before visiting the host country. The host country tax exemption applies to (1) payments received from abroad for the purpose of the individual's maintenance, education, study, research, or training; (2) grants and awards from governmental, scientfic, educational, or other tax-exempt organizations, and (3) $5,000 per taxable year of income from personal services performed in the host country. The exemption extends only for as long as is reasonably necessary to complete the education or training.

This exemption for visiting students, apprentices, and trainees is broader than that provided in the U.S. and OECD model treaties. Among other differences, the exemption in the model treaties applies only to the first of the three categories of income eligible for the exemption under the proposed treaty. The exemption provided in the proposed treaty is similar to that incorporated in some other U.S. income tax treaties with developing countries. It differs, however, from the exemption provided in most of these other treaties in not terminating after a fixed number years (typically five) and in applying to $5,000 per year of personal services income rather than $2,000 or $3,000.

Article 21. (Other income)

This article is a catch-all provision intended to cover items of income not specifically covered in other articles, and to assign the right to tax income from third countries to either the United States or China. Thus, it applies to income from third countries as well as to income from the United States and China.

As a general rule, items of income not otherwise dealt with in the proposed treaty that are derived by residents of either country will be taxable only in the country of residence. This rule, for example, gives the United States the sole right under the treaty to tax income sourced in a third country and paid to a resident of the United States. This article is subject to the saving clause (included in the proposed protocol) in the case of U.S. citizens, so U.S. citizens who are Chinese residents will continue to be taxable by the United States on their third-country income, with a foreign tax credit provided for income taxes paid to China.

The general rule just stated does not apply if the recipient of the income (other than income from real property (Article 6)) is a resident of one country and carries on business in the other country through a permanent establishment or a fixed base, and the right or property in respect of which the income is paid is effectively connected with the permanent establishment or fixed base. In such a case, the provisions of Article 7 (business profits) or Article 13 (independent personal services), as the case may be, will apply.

Moreover, notwithstanding either of the above two rules, if a resident of one country receives income not dealt with elsewhere in the treaty that arises in the other country, the income may be taxed in that other (source) country. A number of existing U.S. income tax treaties apply this rule, but it is not included in the U.S. and OECD model treaties, which generally give the sole right to tax "other income" to the country of residence.

This article is substantially identical to the corresponding article of the Untied Nations model treaty.

Article 22. (Relief from double taxation)

Background

One of the two principal purpses for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. taxpayers to credit the foreign income taxes that they pay against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax on foreign source income only. This limitation is generally computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. Separate limitations on the foreign tax credit are provided for oil extraction income, DISC dividends, FSC dividends, taxable income of a FSC attributable to foreign trade income, and certain interest.

A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may credit foreign taxes paid or deemed paid by that foreign corporation on earnings that are received as dividends (deemed paid credit) (Code sec. 902). These deemed paid taxes are included in the U.S. shareholder's total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credited.

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem is dealt with in other articles that limit the right of a source country to tax income and that coordinate the source rules. This article provides further relief where both China and the United States will still tax the same item of income. China waives its overriding taxing jurisdiction to the extent that this article applies; the United States does the same with respect to U.S. residents who are not U.S. citizens.

The proposed treaty provides separate rules for relief from double taxation for the Untied States and China.

United States

Under the proposed treaty, the United States will allow a foreign tax credit to a U.S. resident or U.S. citizen for income tax paid to China by or on behalf of the U.S. resident or citizen. The proposed treaty further provides that the United States will allow a deemed paid credit to a U.S. corporate shareholder of a Chinese company receiving a dividend from the Chinese company if the U.S. corporate shareholder owns 10 percent or more of the voting rights in the Chinese company. This credit will be allowed for the income tax paid to China, by or on behalf of the distributing Chinese company, on the profits out of which the dividends are paid. Both the regular and deemed paid foreign tax credits are to be determined in accordance with the provisions of U.S. law.

The proposed treaty provides that all Chinese taxes covered by the treaty (Article 2) are considered income taxes for purposes of the U.S. foreign tax credit. Accordingly, all such Chinese taxes will be eligible for the U.S. foreign tax credit under the proposed treaty. These taxes probably would be creditable in the absence of the proposed treaty under U.S. Treasury Department regulations. The Internal Revenue Service has ruled favorably on the creditability of the individual income tax, the income tax concerning foreign enterprises, and the local income tax in private letter rulings issued under an earlier version of the Treasury regulations. The Service has not ruled on the creditability of the income tax on joint ventures.

The proposed treaty provision governing the U.S. foreign tax credit is similar to that found in the U.S. model treaty and in many U.S. income tax treaties.

China

The proposed treaty provides that China is to credit against the Chinese tax imposed on a Chinese resident any U.S. income tax payable under the treaty on the Chinese resident's U.S. source income. The amount of the credit may not exceed the amount of the Chinese tax (computed in accordance with the tax laws and regulations of China) on the U.S. source income. The proposed treaty further provides that China is to allow a credit to a Chinese company receiving a dividend from a U.S. resident company whose shares are owned 10 percent or more by the Chinese company. The credit is to take into account the U.S. income tax payable by the distributing U.S. company on the profits out of which the dividends are paid. All U.S. taxes covered by the treaty (Article 2) are considered income taxes for purposes of the Chinese foreign tax credit.

Source rule

The double taxation article contains a special source rule. Income derived by a resident of one country that may be taxed in the other country under the proposed treaty is deemed to arise in that other country. This source rule is not expressly limited to the double tax relief article, as the corresponding source rule of the U.S. model is. The proposed treaty also omits the U.S. model provision stating that this source rule does not apply in determining foreign tax credits for foreign taxes paid by U.S. residents to third countries, although Treasury's Technical Explanation states that this limitation does apply. In accordance with the understanding expressed by the Committee, this special source rule will not prevent the United States from limiting the availability of a foreign tax credit pursuant to the provisions of section 904(g).

Article 23. (Nondiscrimination)

The proposed treaty contains a nondiscrimination article relating to the taxes covered by the treaty. It is similar to the nondiscrimination article in the U.S. model treaty and to nondiscrimination articles that have been embodied in other recent U.S. income tax treaties.

In general, under the proposed treaty, one country cannot discriminate by imposing other or more burdensome taxes (or requirements connected with taxes) on nationals of the other country than it would impose on its nationals in the same circumstances. Under both the proposed treaty and the U.S. model, this provision applies whether or not the nationals in question are residents of one or both of the countries. This rule of application is qualified in the U.S. model by the rule that a U.S. national residing outside the United States and a national of the U.S. treaty partner residing outside the United States are not in the same circumstances for U.S. tax purposes. The proposed treaty omits this qualifying language but the Committee does not intend the omission to imply a change of meaning from the U.S. model. Treasury's Technical Explanation is in accord with this view.

As indicated above (under Article 3), "nationals" are defined as individuals having the nationality of the United States or China and all legal persons, partnerships, and other bodies of persons deriving their status as such from the laws in force in the United States or China. This definition corresponds closely to that contained in the OECD and United Nations model treaties. Under the U.S. model treaty, by comparison, only U.S. citizens qualify as U.S. nationals for purposes of obtaining nondiscrimination benefits.

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprise carrying on the same activities. Consistent with the U.S., OECD, and United Nations model treaties, however, a country is not obligated to grant residents of the other country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities which it grants to its own residents.

Each country is required (subject to the arm's-length pricing rules of Articles 8 (related persons), 10(7) (interest), and 11(6) (royalties)) to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The term "other disbursements" is understood to include a reasonable allocation of executive and administrative expenses, research and development expenses, and other expenses incurred for the benefit of a gorup or related enterprises.

The rule of nondiscrimination also applies to corporations of one country that are owned in whole or in part by residents of the other country. Enterprises resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one of more residents of the other country, will not be subjected in the first country to any taxation or any connected requirement that is other or more burdensome than the taxation and connected requirements that the first country imposes or may impose on its similar enterprises.

The nondiscrimination article does not override the right of the United States to tax foreign corporations on their dispositions of U.S. real property interests because the effect of the provisions imposing such tax is not discriminatory. The election to be treated as a U.S. corporation under Code section 897(i) precludes the possibility of discrimination.

The saving clause (see discussion of the protocol below) applies to this nondiscrimination article in the case of U.S. citizens. It does not apply in the case of U.S. residents who are not U.S. citizens.

Article 24. (Mutual agreement procedure)

The proposed treaty contains a mutual agreement provision that authorizes the competent authorities of the United States and China to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The application of this provision may result in waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by China and, in the case of U.S. residents who are not U.S. citizens, by the United States. The mutual agreement provision of the proposed treaty follows the standard provision of the U.S. model, with a few differences.

Under the proposed treaty, a person who considers that the actions of one or both of the countries will cause him or her to pay a tax not in accordance with the treaty may present his or her case to the competent authority of the country of which he or she is a resident. The person also may present his or her case to the competent authority of the country of which he or she is a national (but not a resident), but only if the case comes under the nondiscrimination article. The latter rule follows the United Nations model treaty; under the U.S. model treaty, a person may present his or her case to the country of which he or she is a national (but not a resident) without any restriction as to the treaty article under which the case arises.

A person must present his or her case to the competent authority within three years from the first notification of the action that will cause the person to pay tax not in accordance with the treaty. This three-year time limit is taken from the United Nations model; the U.S. model treaty does not impose a time limit on the presentation of a person's case.

Upon the timely presentation of a person's case, the competent authority will make a determination as to whether the objection appears justified. If the objection appears to the competent authority to be justified and if it is not itself able to arrive at a satisfactory solution, then the competent authority will endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation that is not in accordance with the treaty. This provision requires the waiver of the internal statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding that statute of limitations. However, the provision does not authorize the imposition of additional taxes after the statute of limitations has run.

The competent authorities of the countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the treaty. They may also consult together for the elimination of double taxation in cases not provided for in the treaty. Unlike the U.S. model treaty, the proposed treaty does not enumerate particular matters to which the competent authorities might agree. However, the Committee intends that, as under the U.S. model, the competent authorities be authorized to agree to the allocation of income, deductions, credits, or allowances, to the determination of the source of income, and to the common meaning of terms.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. It also authorizes them to meet together for an oral exchange of opinions in order to facilitate reaching an agreement. These provisions make clear that it is not necessary to go through diplomatic channels in order to discuss problems arising in the application of the treaty. They also remove any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or China.

Article 25. (Exchange of information)

This article forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to obtain information so that they can properly administer the treaty. It follows the exchange of information article of the U.S. model treaty, with some significant modifications. It is also similar to the exchange of information articles found in the United Nations and OECD model treaties.

The proposed treaty provides for the exchange of information that is necessary to carry out the provisions of the proposed treaty or the provisions of the domestic laws of the two countries concerning taxes to which the treaty applies insofar as the taxation under those domestic laws is not contrary to the treaty. Following the United Nations model treaty rather than the U.S. model, the proposed treaty states that such exchange of information will be, in particular, for the prevention of fraud or evasion of the covered taxes.

The exchange of information under the proposed treaty is not restricted by Article 1; thus, third-country residents are covered. The U.S. model treaty provides for the exchange of inforamation regarding all taxes imposed by either country (whether or not otherwise covered by the treaty). The exchange of information provided for in the proposed treaty is more limited: the proposed treaty authorizes the exchange only of information regarding taxes generally covered by the treaty (Article 2).

Any information exchanged is to be treated as secret. Exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the treaty applies. Such persons or authorities can use the information for such purposes only. They may disclose the information in public court proceedings or in judicial decisions. Persons involved in the administration of taxes include legislative bodies involved in oversight of the administration of taxes, including their agents such as, for example, the U.S. General Accounting Office, with respect to such information as they consider necessary to carry out their oversight responsibilities.

The proposed treaty contains limitation on the obligations of the countries to supply information. A country is not required to carry out administrative measures at variance with the law and administrative practice of either country, or to supply information which is not obtainable under the laws or in the normal course of the administration of either country, or to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

The U.S. model treaty requires that, upon an appropriate request for information, the requested country obtain the information to which the request relates in the same manner and to the same extent as if its tax were at issue. It also requires that, where specifically requested by the competent authority of one country, the competent authority of the other country provide the information in the form requested. The proposed treaty does not contain these requirements.

The U.S. model treaty also provides that each country will collect taxes for the other country to the extent necessary to insure that benefits of the treaty are not going to persons not entitled to those benefits. The proposed treaty does not contain such a collection provision.

Article 26. (Diplomatic agents and consular officers)

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements. Accordingly, the treaty will not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. Because the saving clause does not apply to Chinese taxes at all, U.S. diplomats who are considered Chinese residents will not be subject to Chinese tax on their diplomatic salaries. Because the saving clause does not apply to U.S. taxes under this article in the case of U.S. residents (who are not U.S. citizens), Chinese diplomats who are considered U.S. residents similarly will not be subject to U.S. tax on their diplomatic salaries.

Article 27. (Entry into force)

The countries are to notify each other in writing, through diplomatic channels, upon the completion of their respective legal procedures to bring the proposed treaty into force. The proposed treaty and proposed protocol will enter into force on the 30th day after the latter of the notifications.

These entry-into-force rules differ from those of the U.S. model treaty which require the countries to exchange instruments of ratification as soon as possible and provide for entry into force upon that exchange.

The proposed treaty and protocol will be effective for income derived in taxable years beginning on or after the January 1st next following the date on which the treaty and protocol enter into force.

Article 28. (Termination)

This proposed treaty will remain in force indefinitely, but either country may terminate it by giving notice in writing through diplomatic channels on or before June 30th in any calendar year after five years from the date on which the treaty enters into force. If a termination occurs, it will be effective with respect to income derived during taxable years beginning on or after the January 1st of the year following that in which the notice of termination is given.

Protocol

At the signing of the proposed treaty on April 30, 1984, a proposed protocol modifying the proposed treaty also was signed. The protocol's provisions, which are discussed below, form an integral part of the proposed treaty.

Paragraph 1. (Scope)

The proposed protocol provides that the treaty does not restrict any tax benefits accorded by the internal laws of, or by an agreement between, the two countries. Thus, the treaty will apply only where it benefits taxpayers. This is a standard U.S. tax treaty provision.

Paragraph 2. (Saving clause)

The proposed protocol adds a "saving clause" to the proposed treaty. Under this clause, the United States reserves the right to tax its citizens, notwithstanding any provision of the treaty. By reason of the saving clause, the United States will continue to tax its citizens who are residents of China as if the treaty were not in force. Under the saving clause, the United States also reserves the right to tax its residents who are not U.S. citizens as if the treaty were not in force, except where this taxation would be inconsistent with certain provisions of the articles dealing with related persons (Article 8), pensions (Article 17), government service (Article 18), teachers and researchers (Article 19), students and trainees (Article 20), double taxation (Article 22), nondiscrimination (Article 23), mutual agreement procedures (Article 24), and diplomatic agents and consular officials (Article 26). For purposes of the treaty (and, thus, for purposes of the saving clause), "residents" include corporations and other entities as well as individuals (Article 4).

The saving clause contained in the proposed protocol differs in certain respects from that contained in the U.S. model treaty and those found in most recent U.S. income tax treaties. Under the U.S. model treaty, both countries generally reserve the right to tax their citizens and residents as if the treaty had not come into effect; under the proposed protocol, only the United States does. Under the U.S. model treaty, there are several exceptions to the rule that a country may tax its citizens notwithstanding any provision of the treaty. The principal exceptions involve the benefits conferred under the treaty with respect to pensions, the foreign tax credit, and nondiscrimination. Under the proposed protocol, the United States reserves the right to tax its citizens without exception. The U.S. model also contains certain exceptions to the saving clause for U.S. residents who are neither U.S. citizens nor have U.S. immigrant status (for example, an exception covering the benefits conferred by the students and trainees article). Similar exceptions are contained in the protocol, but they generally apply to all U.S. residents who are not U.S. citizens, even those with U.S. immigrant status. Under section 877 of the Code, a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income, estate, or gift taxes will, in certain cases, be subject to tax for a period of 10 years following the loss of citizenship; the saving clause of the U.S. model specifically reserves the United States' right to tax former citizens. Although the saving clause provided in the proposed protocol does not contain such a provision, the Committee does not intend the treaty to impose any limitation on the United States' right to tax former citizens. This view is consistent with the Treasury Department's Technical Explanation of the proposed treaty.

Paragraph 3. (U.S. social security, personal holding company, and accumulated earnings taxes)

The proposed protocol provides that the United States generally may impose its social security, personal holding company, and acccumulated earnings taxes notwithstanding any provision of the treaty. However, in a manner similar to certain other U.S. tax treaties, the proposed protocol limits the right of the United States to impose its personal holding company and accumulated earnings taxes with respect to certain companies of the other country. The protocol exempts a Chinese company from the personal holding company and accumulated earnings taxes during a taxable year if, during that taxable year, the company is wholly owned, directly or indirectly, either by one or more individuals who are residents of China (and who are not citizens of the United States) or by the Government of China or any wholly owned agency of that government. In addition, under U.S. law, a Chinese company is subject to the accumulated earnings tax only with respect to income from sources within the United States (Treas. Reg. sec. 1.532-1(c)).

Paragraph 4. (Treaty definition of "person")

The proposed protocol amends the proposed treaty's definition of "person" (Article 3) to include, as the U.S. model's definition does, an estate or trust.

Paragraph 5. ("Tie-breaker" rules)

In assigning (under Article 4) a single country of residence for treaty purposes to an otherwise dual residence individual, the protocol states that the competent authorities of the two countries are to be guided by the "tie-breaker" rules of the U.N. model income tax treaty between developed and developing countries. This provision is discussed in greater detail under Article 4 above.

Paragraph 6. (Reduction of royalty withholding tax)

In general, Article 11 of the proposed treaty limits the tax that the source country may impose on royalties paid to a resident of the other country to 10 percent of the gross amount of the royalties. In the case of royalties paid for the rental of industrial, commercial, or scientific equipment, the proposed protocol provides that the tax allowed under the treaty is to be imposed on 70 percent of the gross amount of the royalties only. The effect of this protocol provision is to reduce to seven percent the maximum source country tax on these types of royalties. This provision is discussed further under Article 11 above.

Paragraph 7. (Limitation on benefits)

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and China as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. This use is known as "treaty shopping." Under certain circumstances, and without appropriate safeguards, the nonresident is able to secure these benefits by establishing a corporation (or other entity) in one of the countreies which, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third-country resident to repatriate funds to that third country from the entity under favorable conditions (i.e., it may be possible to reduce or eliminate taxes on the repatriation) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

The proposed protocol contains a provision intended to prevent third-country companies that are not bona fide residents of the United States or China from using the treaty to secure certain treaty benefits. The protocol provides that the competent authorities of the United States and China may through consultation deny the benefits of the dividend, interest, and royalty articles (Articles 9, 10, and 11) to a company of a third country if the company becomes a resident of one of the countries for the principal purpose of enjoying benefits under the treaty. The principal benefits provided under the dividend, interest, and royalty articles are reduced source country withholding tax rates. This anti-treaty shopping provision is much less detailed than that of the U.S. model treaty and those of most recent U.S. income tax treaties. It is considerably less strict than the anti-treaty shopping provision of the U.S. model. See discussion under "Committee Comments," above.

Paragraph 8. (Existing shipping and aircraft tax agreement)

An agreement between the United States and the People's Republic of China governing the taxation of shipping and aircraft income was signed on March 5, 1982, and is currently in force. The proposed protocol makes clear that the proposed treaty will not alter the tax rules for shipping and aircraft income set forth in that prior agreement.

Exchange of Notes

At the signing of the proposed treaty and protocol, notes were exchanged dealing with the issue of "tax sparing" credits.

In the notes, the United States and China agreed that a tax sparing credit would not be included in the proposed treaty's double taxation relief article (Article 22) at the present time. However, the countries further agreed that the proposed treaty would be promptly amended to incorporate a tax sparing credit provision in the event that the United States amended its laws concerning the provision of tax sparing credits, or the United States reached agreement on the provision of a tax sparing credit with any other country.

This provision reflects the desire of China and other developing countries to have the United States adopt a tax sparing credit. Many developed countries provide a tax sparing credit in order to avoid what, in the view of some, is a conflict with the foreign investment incentive policies of developing countries. A tax sparing credit is an incomee tax credit provided by a country (typically a developed country) against its own tax on income from a developing country. The credit equals the full amount of the developing country's nominal tax on the income, notwithstanding the developing country's reduction or elimination of the tax as part of an investment incentive program. Many developing countries, for example, provide "tax holidays" to residents of other countries who invest in the developing country. Generally, under these tax holidays, the developing countries forego tax on the profits from the foreign-owned business for a period of time. Absent a tax sparing credit, those profits typically would be taxed in full by the country of residence of the business' foreign owner upon repatriation in dividend form. The United States has declined to give tax sparing credits.

This provision is similar to, but goes somewhat beyond, provisions included in certain other U.S. income tax treaties with developing countries. The provisions in the other treaties do not make explicit reference to a tax sparing credit and do not include a specific promise by the United States to allow such a credit upon allowing it to another country. Instead, they commit the United States to resuming discussions, when circumstances permit, with a view to incorporating provisions in the treaty that will minimize interference with incentives offered by the other country and will be consistent with U.S. income tax policy vis a vis other developing countries.

IX. TEXT OF THE RESOLUTION OF RATIFICATION

Resolved (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Agreement between the Government of the United States and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, together with a supplementary protocol and exchange of notes, signed at Beijing on April 30, 1984.

SENATE EXECUTIVE REPORT NO. 99-15

PROTOCOL TO CHINA TAX TREATY

Mr. LUGAR, from the Committee on Foreign Relations, submitted the following report to accompany Treaty Doc. 99-26.

The Committee on Foreign Relations, to which was referred the protocol, signed at Beijing on May 10, 1986, concerning the interpretation of paragraph 7 of the protocol to the agreement between the Government of the United States of America and the Government of the People's Republic of China for the avoidance of double taxation and the prevention of tax evasion with respect to taxes on income, signed at Beijing on April 30, 1984, having considered the same, reports favorably thereon without amendment and recommends that the Senate give its advice and consent to ratification thereof.

PURPOSE

The Protocol amends the China tax treaty (Treaty Doc. 98-30) to insure that only bona fide residents of the contracting states may benefit from the treaty's provisions.

SUMMARY

The Department of the Treasury has provided the following technical explanation of the protocol:

TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE PROTOCOL SIGNED AT BEIJING ON MAY 10, 1986 CONCERNING THE INTERPRETATION OF PARAGRAPH 7 OF THE PROTOCOL TO THE AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF TAX EVASION WITH RESPECT TO TAXES ON INCOME, SIGNED AT BEIJING ON APRIL 30, 1984

The Protocol signed at Beijing on May 10, 1986 (hereafter referred to as "the Protocol") amends the Agreement and accompanying Protocol and Exchange of Letters which were signed at Beijing on April 30, 1984 (hereafter referred to as "the Agreement"). The Protocol contains only one article, which limits the benefits of the Agreement to bona fide residents of the Contracting States. It is intended to prevent residents of third countries from inappropriately using a company which is a resident of one of the Contracting States as a conduit or similar vehicle to obtain tax benefits provided by the Agreement.

The Protocol provides that a person (other than an individual) which is a resident of one of the Contracting States is entitled to relief from taxation by the other Contracting State only under certain conditions. Paragraph 1 provides two alternative conditions of eligibility for benefits under the Agreement. The first condition involves two parts, both objective tests relating to the person deriving the income. The first test is that more than 50 percent of the beneficial interest in such person (or in the case of a company, more than 50 percent of the number of shares of each class of the company's shares) must be owned, directly or indirectly, by any combination of: individuals who are residents of the Contracting States, citizens of the United States, the Contracting States themselves or political subdivisions thereof, or publicly traded companies which are residents of one of the Contracting States. In addition, in the case of reduced taxation at source of dividends, interest, or royalties, not more than 50 percent of the gross income of such person may be used, directly or indirectly, to pay interest to persons other than those enumerated in the ownership test. These ownership and "base erosion" tests are intended to serve as safe harbors for persons which can establish satisfaction of such mechanical tests.

The second condition, which is an alternative to the first two-part condition described above, is met if the person deriving the income is a company which is a resident of a Contracting State and its principal class of shares is the subject of regular and substantial trading on a recognized stock exchange, as defined in paragraph 3. A publicly traded company that is a resident of the United States or the People's Republic of China is considered to have a sufficient nexus with that country, respectively, to entitle it to the benefits of the Agreement.

Paragraph 2 provides a third alternative, under which the benefits of the Agreement are available to a person if the establishment, acquisition and maintenance of the person and the conduct of its operations did not have as a principal purpose the purpose of obtaining the benefits of the Agreement. This condition recognizes that persons resident in third countreis may own an entity that is a resident of the United States or China for valid business reasons, and that granting benefits to such an entity may be consistent with the goals of the Agreement. This condition would be met, for example, if a Chinese company owned by third country residents conducts business operations in China and its U.S. investments are related or incidental to those business activities, or if the aggregate tax burden in China equals or exceeds the tax reduction claimed under the Agreement. It could also be met in other situations.

Paragraph 3 defines a "recognized stock exchange" for the purposes of paragraph 1(b). A recognized stock exchange means U.S. registered stock exchanges, the NASDAQ system in the United States, any national securities exchange approved and established by the People's Republic of China, and any other stock exchange agreed upon by the competent authorities.

Paragraph 4 provides that the competent authorities shall consult each other before benefits are denied under this Article. This consultation obligation is intended to benefit the governments of the two Contracting States. The denial of benefits requires consultation, but is not dependent on the prior agreement of the competent authorities.

The Protocol is an integral part of the Agreement. Thus, its entry into force and duration are covered by Articles 27 and 28, respectively, of the Agreement.

COMMITTEE ACTION

The Committee approved the Protocol by a vote of 16-0 at its June 12, 1986 business meeting. Voting in the affirmative were Senators Lugar, Mathias, Kassebaum, Boschwitz, Pressler, Murkowski, Trible, Evans, Pell, Biden, Sarbanes, Zorinsky, Cranston, Dodd, Eagleston and Kerry.

COMMITTEE COMMENTS

As Senator Lugar indicated at the business meeting, the Protocol will be considered together with the treaty on the Senate floor. The resolution of ratification to this Protocol incorporates the China tax treaty and a supplementary protocol submitted with the treaty. Accordingly, approval of this resolution by the Senate will result in Senate consent to the treaty, the supplementary protocol that accompanied the treaty and this protocol.

Resolved (two-thirds of the Senators present concurring therein), That the Sentate advise and consent to the ratification of the Agreement between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, together with a supplementary protocol and exchange of notes, signed at Beijing on April 30, 1984, and a protocol concerning the interpretation of paragraph 7 of the supplementary protocol, signed at Beijing on May 10, 1986.

TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF TAX EVASION WITH RESPECT TO TAXES ON INCOME

The Agreement, an accompanying Protocol, and an exchange of letters were signed in Beijing on April 30, 1984. Hereafter, the term "Agreement" refers to the three documents. The term "Agreement" has the same meaning as "Treaty" or "Convention", and the Agreement is subject to the same ratification requirements and has the same force as a Convention or Treaty.

The Agreement is based on the model income tax conventions published by the Organization for Economic Cooperation and Development in 1977, the United Nations in 1980, and the U.S. Treasury Department in 1981.

This technical explanation is an official guide to the Agreement. It reflects policies behind particular provisions as well as understandings reached with respect to the interpretation and application of the Agreement.

Article 1.

This article states the general rule that the persons affected by the Agreement are residents of the United States or China or of both countries. The term "resident" is defined in Article 4. Certain articles may also apply to nonresidents; see, for example, Article 23, which concerns nondiscrimination, and Article 25, concerning exchanges of information. Article 1 is supplemented by Articles 1 and 2 of the Protocol.

Article 1 of the Protocol provides that the Agreement does not restrict any benefits provided by the laws of either Contracting State or by any other agreement between the Contracting States. This rule reflects the principle that a double taxation agreement should not increase the overall tax burden which would result in the absence of the Agreement. For example, if the Agreement permits a Contracting State to tax an item of income which under the law of that State is exempt from tax, the statutory exemption applies. A U.S. taxpayer, however, may not make inconsistent choices between the rules of the Internal Revenue Code ("the Code") and the rules of the Agreement.

Article 2 of the Protocol is a simplified version of the traditional "saving clause" which preserves the right of the United States to tax its citizens and residents under its domestic law. The rule is drafted unilaterally, as China does not tax on the basis of citizenship and does not consider such a provision necessary to preserve its taxation of, and implement the Agreement with respect to, Chinese residents. The reference to "citizens" of the United States is understood by the parties to include former citizens whose loss of citizenship had as one of its principal purposes the avoidance of U.S. tax. Such former citizens are taxable in accordance with section 877 of the Code. Certain benefits of the Agreement are available to U.S. residents, as defined in Article 4 of the Agreement. Those benefits are the right to a correlative adjustment of tax liability as provided in paragraph 2 of Article 8, the exemption from U.S. tax of Chinese social security benefits provided in paragraph 2 of Article 17, the provisions concerning government employees, teachers and students of Articles 18, 19 and 20, and the benefits of Articles 22, 23, 24 and 26 concerning, respectively, relief from double taxation, nondiscrimination, the mutual agreement procedure, and diplomats. Further, it is understood that the benefits of the provisions concerning relief from double taxation, nondiscrimination, and the mutual agreement procedure will also be available to nonresident U.S. citizens to the extent applicable under the specific terms of those articles.

Article 2.

Paragraph 1 of this article enumerates the existing taxes to which the Agreement applies in each Contracting State. In the United States, these are the Federal income taxes imposed by the Code. As explained in Article 3 of the Protocol, U.S. social security taxes are not covered by the Agreement. The personal holding company tax and the accumulated earnings tax are also not covered by the Agreement, except that they will not apply to a Chinese company which is wholly owned, directly or indirectly, by individual residents of China who are not U.S. citizens or by the Government of China or a wholly owned agency thereof.

The Chinese taxes covered by the Agreement are the individual income tax, the income tax concerning joint ventures with Chinese and foreign investment, the income tax concerning foreign enterprises, and the local income tax.

Paragraph 2 provides that the Agreement shall also apply to taxes imposed after the date of signature of the Agreement, provided that they are substantially similar to those enumerated in paragraph 1. The competent authorities agree to notify each other of substantial changes in their respective income tax laws.

Article 3.

Article 3 defines some of the principal terms used throughout the Agreement. Unless the context otherwise requires, the terms defined in this article have a uniform meaning throughout the Agreement. A number of important terms are defined in other articles. For example, the term "resident of a Contracting State" is defined in Article 4, and the term "permanent establishment" is defined in Article 5. The terms "dividends," "interest," and "royalties" are defined in Articles 9, 10, and 11, respectively.

The geographical territory of the two Contracting States is defined to include their continental shelf areas to the extent consistent with international law and their respective domestic laws. Thus, for example, activities taking place on the seabed or subsoil beyond the territorial sea of the United States will be considered to take place within the United States for purposes of the Agreement, provided that the United States has jurisdiction over such areas in accordance with international law and U.S. domestic law. The United States will interpret this definition in accordance with section 638 of the Internal Revenue Code and the regulations thereunder. The "United States" does not include Puerto Rico, the Virgin Islands, Guam, or any U.S. territory or possession. The "People's Republic of China" does not include Hong Kong, as Chinese tax laws are not in effect there. Moreover, in accordance with the Agreement between the United Kingdom and China on the future of Hong Kong, the taxes imposed by the Hong Kong Special Administrative Region will continue to be independent of the tax laws of the Central People's Government, and therefore the Agreement will not apply to Hong Kong even after 1997.

The term "person" includes an individual, a company, a partnership, and any other body of persons. It also includes, as provided in Article 4 of the Protocol, an estate or a trust. The term "person" is important because the Agreement applies to "persons" who are residents of one or both Contracting States and residence in a State is defined in terms of "persons" meeting certain criteria. A "company" is any entity treated as a corporation for tax purposes.

The term "nationals" means individuals having the nationality of a Contracting State and legal entities deriving their status as such from the law in force in a State.

The competent authority in the case of China is the Ministry of Finance or its authorized representative and in the case of the United States is the Secretary of the Treasury or his authorized representative.

Paragraph 2 provides that, in the case of a term not defined in the Agreement, the domestic tax law of the State applying the Agreement shall control, unless the context requires a different interpretation or unless the competent authorities agree on a common meaning in accordance with paragraph 3 of Article 24 (concerning the mutual agreement procedure).

The Agreement does not include a definition of the term "international traffic" because that definition, as well as the substantive rules concerning the taxation of international shipping and air transport income, is contained in the Agreement Between the Government of the United States of America and the Government of the People's Republic of China with Respect to Mutual Exemption From Taxation of Transportation Income of Shipping and Air Transport Enterprises, which was signed on March 5, 1982 and entered into force on September 23, 1983.

Article 4.

This article defines those persons who are residents of a Contracting State and thus entitled to the benefits of the Agreement. The definition begins with a person's liability to tax under domestic law. Paragraph 1 lists several criteria which may be used in domestic law to determine residence for tax purposes. Citizenship is not one of the criteria; thus a U.S. citizen resident in a third country is not treated as a U.S. resident for purposes of this Agreement. The reference to persons "liable to tax" is not meant to exclude organizations of either country which are tax-exempt under special provisions of its domestic law, such as charities. However, it would not include a person liable to tax only in respect of income from sources in the taxing country, such as a resident of a third country subject to tax in the United States or China only on a source basis. A U.S. partnership, estate or trust is a resident only to the extent that the income it derives is subject to tax either in the hands of the entity or of its partners or beneficiaries.

Paragraph 2 provides that, where an individual is considered to be a resident of both Contracting States under their respective domestic laws, the competent authorities shall consult together to determine of which State the individual shall be a resident for purposes of the Agreement. In making that determination, the competent authorities will be guided by the rules of paragraph 2 of Article 4 of the United Nation's Model Double Taxation Convention between Developed and Developing Countries. (See Article 5 of the Protocol.) Those rules are the same as the rules contained in the corresponding paragraph of the OECD and U.S. Models. The first test is where the individual has his permanent home. If he has a permanent home in both countries, the second test is where his personal and economic ties are closer (center of vital interests). If that test is inconclusive, or if the individual does not have a permanent home in either State, the next test is his place of habitual abode. The fourth test is nationality. If the individual is a national of both States or of neither of them, the competent authorties are instructed to settle the issue so as to assign a single State of residence. Once established under this article, the residence of the individual remains the same for all purposes of the Agreement.

For U.S. tax purposes, a company is a resident of the United States if it is created or organized under the laws of a state or the District of Columbia. For Chinese tax purposes, a company is a resident of China if its place of management (head office) is in China. Under paragraph 3, where a company is a resident of both Contracting States under their respective domestic laws, the competent authorities will attempt to determine a single State of residence through consultations. However, it would not be the policy of the U.S. competent authority to agree to treat an entity incorporated in the United States as not a U.S. resident. If the competent authorities are unable to reach Agreement, the company will not be considered a resident of either State for purposes of enjoying benefits under the Agreement. Thus, for example, dividends paid to a resident of China by a dual resident company would be eligible for the reduced U.S. withholding rate of 10 percent. However, if a dual resident corporation paid a dividend to a U.S. resident, the statutory U.S. tax would apply with respect to that dividend. Dividends, interest or royalties arising in either Contracting State and paid to a dual resident corporation are not entitled to the reduced rates provided for in the Agreement.

Paragraph 4 deals with a case where a company is a resident of the United States for purposes of the

Agreement, but is also a resident of a third country under another tax treaty between China and the third country (e.g. a corporation created under U.S. law but having its head office in Japan). Instead, the Agreement between China and the third country will prevail, and the company will be considered a resident of the third country and not of the United States for purposes of this Agreement. Thus, the company will receive the benefits of the other Agreement between China and the third country.

Article 5.

The rules for taxation by a Contracting State of business income derived by a resident of the other State utilize the concept of a "permanent establishment." This article illustrates that concept.

Paragraph 1 defines a permanent establishment in general terms as a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Paragraph 2 contains an illustrative list of permanent establishments. These illustrations are the same as those in the U.S. Model. They are a place of management, a branch, an office, a factory, a workshop, and a place of extraction of natural resources, such as a mine, well, or quarry.

Subparagraph 3(a) provides that a construction site, assembly or installation project, or supervisory activities in connection with such a site or project, constitutes a permanent establishment if the site, project, or activities continue for more than six months. In such a case, a permanent establishment exists from the first day when work physically begins within the territory of the other Contracting State, including preparatory work. Each site or project and each enterprise is considered separately. A series of contracts or projects which are interdependent both commercially and geographically are to be treated as a single project for the purpose of applying the six month test. For example, a "turn-key" project in which a facility is constructed and equipment installed in it would be a single project. However, it is possible that a project which constitutes a permanent establishment for the general contractor may not be a permanent establishment for a subcontractor if the latter performs services there for less than six months. For example, a subcontractor could install equipment at one site for four months and provide supervisory services at a separate site for an unrelated contractor for three months without itself having a permanetn establishment.

Subparagraph 3(b) provides that an installation, drilling rig or ship used to explore for or exploit natural resources constitutes a permanent establishment if it continues for more than three months. A series of projects or contracts will be interpreted in the same manner as in the case of construction sites.

Subparagraph 3(c) provides that the furnishing of servicces by an enterprise through employees or other personnel will constitute a permanent establishment of the enterprise in that other State when the activities in the other Contracting State continue for more than six months within a twelve month period.

Paragraph 4 identifies activities which may be carried on in a Contracting State which will not constitute a permanent establishment even if conducted through a fixed place of business. The activities enumerated are the same as in the U.S. Model. The use of facilities solely to store, display, or deliver goods belonging to an enterprise does not constitute a permanent establishment. Nor does the maintenance of a stock of goods belonging to the enterprise solely for the purpose of storage, display, delivery, or processing by another enterprise. An enterprise may maintain a fixed place of business solely to purchase goods or collect information or to carry on any other preparatory or auxiliary activity for the enterprise without being considered to have a permanent establishment. Any combination of the enumerated activities also does not constitute a permanent establishment, subject to the condition that the combined activity is of a preparatory or auxiliary character for the enterprise.

Paragraphs 5 and 6 concern the use of agents. Under paragraph 5, which is the same as in the U.S. Model, a dependent agent who acts on behalf of an enterprise and habitually exerceises an authority to conclude contracts in the name of that enterprise is deemed to be a permanent establishment of that enterprise (whether or not there is a fixed place of business) unless the activities of the agent are limited to activities which would not constitute a permanent establishment under paragraph 4 if carried on directly by the enterprise. Paragraph 6 provides that an enterprise will not be considered to have a permanent establishment in the other State merely because it uses in that other State the services of an independent agent acting in the ordinary course of his business. However, an agent will not be considered independent if he acts wholly or almost wholly on behalf of that enterprise and it is shown that the transactions between the agent and the enterprise were not at arm's length.

Paragraph 7 states that control of one company by another does not, in and of itself, constitute either company a permanent establishment of the other. The determination whether a subsidiary is a permanent establishment of its parent corporation or conversely, or whether two or more subsidiaries of the same corporation are permanent establishments of the parent or of each other is made by reference to the tests set out in paragraphs 1 through 6.

Article 6.

Paragraph 1 provides that income derived by a resident of a Contracting State from real property situated in the other Contracting State may be taxed in the State where the property is situated. The United States may also tax such income of its citizens and residents in accordance with paragraph 3 of Article 1 (General Scope) of the Protocol.

Paragraph 2 provides that "real property" is defined in accordance with the law of the Contracting State where the property is situated. It, in any case, includes property acccessory to real property, such as livestock and equipment used in agriculture and forestry, and payments for the use of natural resource deposits. It does not include ships and aircraft.

Paragraph 3 elaborates that income from immovable property includes income from the direct use, letting, or use in any other form of such property.

Paragraph 4 further elaborates that real property of an enterprise and real property used for performing independent personal services are also covered by this article.

Article 7.

This article provides rules governing the taxation by a Contracting State of incoem from business activity carried on in that State by a resident of the other Contracting State.

Paragraph 1 provides that business profits of an enterprise of one Contracting State shall be taxable only in that State except to the extent that such profits are attributable to a permanent establishment through which the enterprise carries on business activities in the other Contracting State.

Paragraph 2 provides that the profits to be attributed to a permanent establishment are those which it might be expected to make if it were an independent enterprise engaged in similar activities under similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment and all other related persons.

Paragraph 3 provides that deductions shall be allowed for expenses incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and administrative expenses, without regard to where such expenses are incurred. However, the profits of the permanent establishment are not to be reduced by deductions for interest or royalties paid to the head office other than as reimbursements of costs incurred.

Paragraph 4 provides that, where the tax law of a Contracting State uses a deemed profit basis to determine the net income of a specific industry, the provisions of paragraph 2 do not preclude the use of that method provided that the results are consistent with the principles of this article. For example, for administrative reasons, China deems the profit of foreign shipping, airline, and oil drilling companies attributable to their Chinese operations to be a percentage of their gross receipts from China. Currently, the taxable income in such cases is deemed to be 10 percent of the gross income and that amount is subject to tax at the ordinary rates unless exempt under another provision of the Agreement. Such an approach is acceptable as long as its results are consistent with arm's length principles.

Paragraph 5 states that the mere purchase by a permanent establishment of goods or merchandise for the enterprise shall not result in profits being attributed to the permanent establishment.

Paragraph 6 provides that, unless there is good and sufficient reason to the contrary, the same method of determining profits attributable to the permanent establishment shall be used each year. In the United States, such a change may be a change in accounting method requiring the approval of the Internal Revenue Service.

Paragraph 7 provides that, where business profits include items of income dealt with in other articles of the Agreement, the provisions of those other articles govern. For example, the taxation of dividends, interest, and royalties is controlled by Articles 9, 10, and 11, respectively; however, the terms of those articles provide that where dividends, interest, or royalties derived by a resident of a Contracting State are effectively connected with (attributable to) a permanent establishment in the other State, the provisions of this article apply and the item of income is taxed as business profits.

Article 8.

This article provides that, where related persons engage in transactions which are not at arm's length, the Contracting States may make appropriate adjustments to their taxable income and tax liability.

Paragraph 1 states the general rule that, where an enterprise of one Contracting State and an enterprise of the other State are related through management, control, or capital and their commercial or financial relations differ from those which would prevail between independent enterprises, the profits of the enterprises may be adjusted to reflect the profits which would have accrued if the two enterprises were independent.

Paragraph 2 provides that, where one of the Contracting States increases the profits of an enterprise of that State to the amount that would have accrued to the enterprise had it been independent of an enterprise of the other Contracting State, the second State shall, to the extent it agrees that the redetermination accurately reflects arm's length conditions, make a correlative adjustment, decreasing the amount of tax which it has already imposed on those profits. In determining such adjustments, due regard is to be paid to the other provisions of the convention. The competent authorities of the two States may consult each other in implementing this provision.

It is understood that each Contracting State may apply its internal law in determining liability for its tax. For example, although paragraphs 1 and 2 refer to allocations of "profits" and "taxes," it is understood that such terms also include the components of the tax base and of the tax liability, such as income, deductions, credits, and allowances. The Untied States will apply its rules and procedures under Code section 482.

Article 9.

This article limits the tax which a Contracting State may impose on dividends paid by a company which is a resident of that State to a resident of the other Contracting State.

Paragraph 1 confirms that such dividends may be taxed in the State of residence of the shareholder.

Paragraph 2 provides that the dividends may also be taxed in the Contracting State of which the paying company is a resident. However, if the beneficial owner is a resident of the other Contracting State, the tax may not exceed 10 percent of the gross dividend. Although the language used, which is taken from the OECD and U.N. Models, refers to the recipient being the beneficial owner, it is understood (consistent with the OECD commentary) that the intended meaning is that the reduced rate will apply when the beneficial owner is a resident of the other Contracting State, even when the recipient of the dividend may be a nominee for such resident.

Paragraph 3 defines the term "dividends" for purposes of this article. The definition, which is the same as that in the U.S. Model, is relevant only for determining the appropriate taxation at source. It does not govern for purposes of the country of residence of the shareholder, which applies its own law to the extent that characterizing an item of income is relevant.

Paragraph 4 provides that, where a resident of a Contracting State derives dividends from the other Contracting State and the holding is effectively connected with (the dividends are attributable to) a permanent establishment or fixed base through which the owner of the dividends carries on business in that other State, the dividends are taxable in accordance with the provisions of Article 7 or Article 13 rather than under this article. This paragraph does not automatically attribute dividends derived by a company having a permanent establishment in the source country to that permanent establishment (the "force of attraction" rule found in some early tax treaties).

Paragraph 5 provides that a Contracting State may not tax dividends paid by a company which is not a resident of that State except to the extent permitted under paragraph 2 or 4 of this article, i.e. to the extent that the dividends are paid to a resident of that State (or, in the case of the United States, a U.S. citizen residing in a third State) or the dividends are attributable to a permanent establishment or fixed base in that State. Thus, the United States will not tax dividends which are considered to be from U.S. sources under Code section 861(a)(2)(B) if paid by a Chinese corporation. China does not impose a tax on distributions of a foreign corporation out of the profits of its Chinese permanent establishment or a supplementary tax on the profits of a Chinese branch of a foreign corporation.

In accordance with the "saving clause" of paragraph 2 of the Protocol, the United States may in any event tax dividends derived by U.S. citizens.

Article 10.

This article limits the tax which a Contracting State may impose on interest arising in that State and paid to a resident of the other Contracting State.

Paragraph 1 confirms that such interest may be taxed in the State of residence of the recipient.

Paragraph 2 provides that such interest may also be taxed in the Contracting State in which it arises. However, if the beneficial owner is a resident of the other Contracting State, the tax may not exceed 10 percent of the gross interest. (See also the discussion of the corresponding provision in Article 9.)

Paragraph 3 provides, as an exception to paragraph 2, that interest arising in a Contracting State which is derived by the government of the other Contracting State, a political subdivision or local authority thereof, or the Central Bank or any financial institution wholly owned by the government of that other State or by any resident of that other State with respect to debt indirectly financed by any of the above (e.g. loans indirectly financed by Eximbank) is exempt from tax in the State in which it arises.

Paragraph 4 defines "interest" for purposes of this article. It includes income from debt-claims of all kinds, including mortgage interest and original issue discount. The definition, which is relevant only for determining the appropriate taxation at source, permits the United States to apply its rules regarding the distinction between interest and dividends pursuant to section 385 of the Code. It is understood that penalties for late payment are not interest.

Paragraph 5 provides that, where a resident of one Contracting State derives interest which arises in the other Contracting State and the debt claim is effectively connected with (i.e. the interest is attributable to) a permanent establishment or fixed base through which the owner of the interest carries on business in that other State, that interest is taxable in accordance with the provisions of Article 7 or Article 13 rather than under this article. Thus, interest derived by a resident of China which arises in the United States and is attributable to a U.S. permanent establishment of that resident may be taxed by the United States in accordance with Article 7.

Paragraph 6 provides a source rule for interest payments. Generally, interest is deemed to arise in the state of residence of the payer. However, where the interst is attributable to debt incurred by or for a permanent establishment or fixed base in one of the Contracting States and is borne (deducted from taxable income) by that permanent establishment or fixed base, the interest is deemed to arise where the permanent establishment or fixed base is located.

Paragraph 7 states that this article does not apply to interest payments between related persons in excess of the amount which would have been agreed upon at arm's length. Such excess amount shall be taxable according to the laws of each Contracting State, with regard also to the other provisions of this Agreement. For example, if the excess amount is taxable as a dividend, the tax imposed will be subject to the provisions of Article 10 (Dividends).

In accordance with the "saving clause" of paragraph 2 of the Protocol, the United States may in any event tax interest derived by U.S. citizens.

Article 11.

This article limits the tax which a Contracting State may impose on royalites arising in that State and paid to a resident of the other Contracting State.

Paragraph 1 confirms that such royalties may be taxed in the State of residence of the recipient.

Paragraph 2 provides that such royalties may also be taxed in the Contracting State in which they arise. However, if the beneficial owner is a resident of the other Contracting State, the tax may not exceed 10 percent of the gross royalty. (See also the discussion of the corresponding provision in Article 9.) In recognition of the expenses associated with the leasing of industrial, commercial, and scientific equipment, paragraph 6 of the Protocol provides that in such cases the tax shall be imposed on 70 percent of the gross amount, i.e. the tax may not exceed 7 percent of the gross rental payment.

Paragraph 3 defines the term "royalties" for purposes of this article. The definition includes payments for the right to use a copyright, trademark, patent, design, models, secret formula or process, know-how, or similar property or rights. Payments for film rentals and for the leasing of equipment are also included, and it is understood that the definition includes royalties contingent on the sale or use of the property or right.

Paragraph 4 provides that, where a resident of one Contracting State derives royalties which arise in the other Contracting State and the right or property is effectively connected with (i.e. the royalties are attributable to) a permanent establishment or fixed base through which the owner of the royalties carries on business in that other State, the royalties are taxable in accordance with the provisions of Article 7 or Article 13 rather than under this article.

Paragraph 5 provides a source of rule for royalty payments. In general, a royalty is considered to arise in a Contracting State if paid by the government or a resident of that State. However, if a permanent establishment or fixed base of the payor in one of the States incurs the liability to pay the royalties and bears the payment (deducts it in arriving at taxable income) the royalty is considered to arise in the State where the permanent establishment or fixed base is located. Moreover, if under these rules a royalty is not considered to arise in either State, but it relates to the use of, or the right to use, property in a State, the royalty is considered to arise in the State where the property is used (or where there is a right to use it). Thus, for example, if a resident of China were to license a patent to a third country company, which in turn sublicensed it for use in the United States, the United States would tax the license payment by the third country company to the resident of China, subject to the limitation in paragraph 2. The sublicense payment by the U.S. user to the third country resident would not be covered by the Agreement and would be subject to U.S. tax under U.S. law or the provisions of a U.S. tax treaty with that third country, if applicable.

Paragraph 6 states that this article does not apply to royalties paid between related persons in excess of the amount which would have been agreed upon at arm's length. Such excess amount shall be taxable according to the law of each Contracting State, with regard also to the other provisions of this Agreement. For example, if the excess royalty is taxable as a dividend, it will be subject to the provisions of Article 9.

In accordance with the "saving clause" of paragraph 2 of the Protocol, the United States may in any event tax royalties derived by U.S. citizens.

Article 12.

This article specifies the situations in which a Contracting State may tax gains derived by a resident of the other Contracting State. The term "gains" includes amounts treated as capital gains and as ordinary income.

Paragraph 1 provides that gains derived by a resident of a Contracting State from the alienation of real property situated in the other Contracting State may be taxed by the State where the property is located.

Paragraph 2 provides that gains derived by a resident of a Contracting State with respect to movable property forming part of a permanent establishment or a fixed base maintained by that resident in the other Contracting State and gains from the alienation of such a permanent establishment or fixed base may be taxed where the permanent establishment or fixed base is located.

Paragraph 3 reserves to the State of residence the exclusive right to tax gains of a resident of a Contracting State from the alienation of ships, aircraft, operated in international traffic, and related personal property, such as containers.

Paragraph 4 provides that gains derived from the alienation of shares of a company the assets of which directly or indirectly consist principally of real property situated in a Contracting State may be taxed in the State where the real proeprty is situated.

Paragraph 5 provides that gains derived from the alienation of shares, other than those covered by paragraph 4, which represent a participating of 25 percent or more in a company which is a resident of a Contracting State may be taxed in that State. For example, China may tax the gain derived by a U.S. company from the alienation of its 25 percent or greater participation in a Chinese corporate joint venture.

Paragraph 6 provides that gains from the alienation of any property not referred to in paragraphs 1 through 5 may be taxed in the State in which they arise. Thus, gains on the disposition of a U.S. real property interest, to the extent not taxable under the preceding paragraphs, are taxable under this paragraph in accordance with the provisions of the Foreign Investment in Real Property Tax Act, as amended.

The gains covered in this article may also be taxed in the State of residence of the alienator, subject to the provisions of Article 22 concerning the avoidance of double taxation.

In accordance with paragraph 2 of the Protocol, the United States may also tax its citizens.

Article 13.

This article provides that income derived by an individual resident of a Contracting State from performing independent personal services may be taxed in the other Contracting State only if the individual is present in that other State for more than 183 days in the calendar year or has a fixed base regularly available to him in that other State. In such a case, that other State may tax the income attributable to the services performed there or to that fixed base, as the case may be.

The concept of a "fixed base" is analogous to that of a "permanent establishment" as defined in Article 5. Thus, a fixed base means a fixed place of business used with some continuity for performing independent services. It would not include a hotel room unless used as an office or work site on a continuing basis. The rules of Article 7 should also be applied in taxing the profits attributable to a fixed base, e.g. taxation on a net basis using arm's-length principles.

Independent personal services are, in general, services performed by an individual for his own account where he receives the income and bears the losses arising from such services. They include services of professional persons, such as doctors and lawyers, but also other services performed by sole proprietors or partners.

In accordance with paragraph 2 of the Protocol, the United States may in any event tax its citizens.

Article 14.

This article specifies when personal service income earned by an employee who is a resident of a Contracting State may be taxed by the other Contracting State.

Paragraph 1 provides the basic rule that such employment income may be taxed only in the employee's State of residence, unless the services are performed in the other Contracting State.

Paragraph 2 provides that, even where the services are performed in the other Contracting State, the income derived may not be taxed by that other State if three conditions are met: (1) the recipient is present in that other State for not more than 183 days in the calendar year; (2) the remuneration is paid by or on behalf of an employer who is not a resident of that other State; and (3) the remuneration is not borne by (deducted from the taxable income of) a permanent establishment or a fixed base of that employer in that other State. If any one of the three conditions is not met, e.g., if the remuneration is borne by a permanent establishment of the employer in the State where the services are performed, the income may be taxed by that State. In any such case, the right of the source State to tax is limited to the income attributable to services performed in that State.

In accordance with paragraph 2 of the Protocol, the United States may in any event tax its citizens.

Article 15.

This article provides that a Contracting State may tax a resident of the other Contracting State with respect to payments for his services as a director of a company which is a resident of the first-mentioned State. Payments for services as an officer or employee of such a company are covered under Article 13 or 14.

In accordance with paragraph 2 of the Protocol, the United States may in any event tax its citizens.

Article 16.

This article specifies when a Contracting State may tax the remuneration of entertainers and athletes who are residents of the other Contracting State. It provides certain exceptions to the provisions of Articles 13 and 14. However, income from services rendered by producers, directors, technicians and others who are not artistes and athletes is taxable in accordance with Article 13 or 14, as the case may be.

Paragraph 1 provides that a Contracting State may tax income derived by a resident of the other Contracting State from the performance of services in the first State as an entertainer or athlete, unless the activities are exercised in accordance with a cultural exchange program agreed upon by the two Governments, in which case the host State agrees to exempt such income from tax. The exception for cultural exchange programs is expected to cover most, if not all, such exchanges at the present time.

Paragraph 2 provides that, where income for services performed by an entertainer or athlete accrues to another person, it may be taxed in the State where the activities are performed, without regard to the other provisions of the Agreement. Although this provision is drafted broadly, it is understood that it will be interpreted in accordance with the policy of the U.S. model and the commentary to the OECD model provision; i.e. the intent is to prevent abuse of the Convention by diverting income to a person, other than the individual performing the services (for example, by having the remuneration paid to a corporation which does not have a permanent establishment in the State where the services are performed). The paragraph is not intended to impose tax in cases where there is no tax avoidance motive, for example, when a payment is made to an orchestra on behalf of its members who performed in a concert.

In accordance with paragraph 2 of the Protocol, the United States may in any event tax its citizens.

Article 17.

This article deals with the taxation of private pensions and social security benefits. Pensions in consideration of government employment are covered under Article 18. Paragraph 1 provides that pensions in respect of private employment derived by a resident of a Contracting State may be taxed only in that State. On the other hand, public payments, such as social security benefits or public welfare payments, paid by a Contracting State may be taxed only in the paying State. This provision is excepted from the "saving" clause of paragraph 2 of the Protocol, so the United States will not tax its residents on social security benefits paid to them by the People's Republic of China.

Article 18.

This article deals with the taxation of remuneration and pensions paid by the government of a Contracting State with respect to the performance of governmental functions for that State. It is based on the corresponding article in the OECD and UN model draft conventions.

Paragraph 1 provides that remuneration paid by the government of a Contracting State or a political subdivision or local authority thereof to an individual for services rendered may be taxed only in that State unless the services are performed in the other State and the individual is either a national of that other State or became a resident of that other State other than solely for the purpose of rendering such services. In the latter case, the remuneration may be taxed only in that other State. For example, the United States may tax the remuneration of an employee of the Embassy of the People's Republic of China if the individual is a U.S. citizen or was a U.S. resident prior to being hired by the Embassy, but it may not tax an employee who was a nonresident alien of the United States when assigned to work at the Embassy.

Paragraph 2 provides that a pension paid by or out of funds created by the government of a Contracting State or a political subdivision or lcoal authority thereof to an individual for services rendered may be taxed only in that State unless the individual is both a resident and a national of the other Contracting State. Thus, the United States may tax such a pension paid by the People's Republic of China to a U.S. resident citizen but not to a resident alien. In the latter case, the exemption from U.S. tax is preserved by paragraph 3 of the Protocol.

The exemptions provided in this article are limited to remuneration and pensions with respect to services of a governmental nature. Paragraph 3 explains that services and pensions in government owned business are covered by Article 14, 15, 16, or 17 as the case may be. Whether functions are of a governmental nature is determined by reference to the concept of a governmental function in the State in which the income arises. For example, in the United States, employment by a government-owned airline does not constitute employment of a governmental nature.

Article 19.

This article provides that a resident of a Contracting State who goes to the other Contracting State for the primary purpose of teaching, lecturing, or conducting research at an accredited educational institution or scientific research institution in that other State will be exempt from tax in that other State on the remuneration for such activities for a period of up to three years in the aggregate. Thus, for example, a resident of China who visits the United States to conduct research at the National Institute of Health (NIH) for two years, 1986 and 1987, returns to China for a year, and the comes back for another year of research at NIH in 1989 would be exempt from tax on his NIH remuneration for each of the three years. However, if he stayed at NIH in 1990 or returned at a later time the exemption would no longer be available. The exemption provided in this article is not available if the research is not undertaken in the public interest, but for the private gain of a specific person or persons.

This article is excepted from the "saving clause" of paragraph 2 of the Protocol, so its benefits are available to persons who otherwise qualify even if they become U.S. residents.

Article 20.

This article provides that a resident of a Contracting State who goes to the other Contracting State for the purpose of education, training or obtaining technical experience shall be exempt from tax in that other State on payments received from abroad for the purpose of his maintenance, education, or training, grants from a tax-exempt organization, and up to $5,000 per year of income for personal services performed in that other State. These exemptions may be claimed only for the period reasonalby necessary to complete the education or training. In some cases, the course of study or training may last less than year. For most undergraduate college or university degrees the appropriate period will be four years. For some advanced degrees, such as in medicine, the required period may be longer, e.g. seven years.

This article is excepted from the "saving clause" of paragraph 2 of the Protocol, so its benefits are available to persons who otherwise qualify even if they become U.S. residents.

Article 21.

Paragraph 1 provides that any income of a resident of a Contracting State which is not covered by other articles of the Agreement may be taxed only in that State. Prizes or winnings would be taxable under this article. (However, see also paragraph 3, which permits taxation at source).

Paragraph 2 provides an exception for income (other than income from real property) which is attributable to a permanent establishment or fixed base which the resident maintains in the other Contracting State. Such income, which includes dividends, interest and royalties derived by a resident of a Contracting State from third States which are attributable to a permanent establishment or fixed base of that resident in the other Contracting State, is taxable under the provisions of the Article 7 13. The exception for income from real property means that income of a resident of a Contracting State from real property which is situated in a third State may not be taxed by the other Contracting State even if attributable to a permanent establishment of the resident in that other State.

Paragraph 3 overrides paragraphs 1 and 2 to permit a Contracting State to tax income derived by a resident of the other Contracting State and not dealt with in the preceding articles, if it arises in that first-mentioned State.

Article 22.

This article describes the manner in which each country will undertake to avoid double taxation of its residents, and in the case of the United States, its citizens.

Paragraph 1 provides that China shall allow a foreign tax credit for income taxes paid to the United States up to the amount of Chinese tax on that income. A credit is also granted for U.S. income tax paid with respect to the profits of a U.S. company out of which dividends are paid to a Chinese company which owns at least 10 percent of the shares of the company paying the dividend.

Paragraph 2 provides that the United States, in accordance with its law, shall allow a foreign tax credit for income taxes paid to China by or on behalf of a U.S. resident or citizen and for Chinese income tax paid with respect to the profits of a Chinese company out of which dividends are paid to a U.S. company owning at least 10 percent of the voting rights of the company paying the dividends. For this purpose, the Chinese taxes referred to in Article 2 (paragraph 1(a) and 2) are considered income taxes. The guarantee of a foreign tax credit provided in this paragraph is independent of the statutory grant of a credit under sections 901–903 of the Code, but the amount of the credit to be allowed is determined in accordance with the limitations provided in the Code, (e.g., section 904(g)).

For purposes of applying the foreign tax credit for Chinese taxes provided in this Article, paragraph 3 provides that income derived by a resident of a Contracting State will be deemed to arise in the other Contracting State if such income may be taxed in the other State in accordance with this Agreement. Thus, for example, dividends, interest and royalties which may be taxed by China in accordance with Article 10, 11 or 12 will be considered Chinese source income.

This article is not affected by the saving clause. Thus, the benefits may be claimed by a U.S. resident or citizen. Alternatively, a U.S. resident or citizen may rely on the rules of the Code. However, the taxpayer may not make inconsistent choices between the rules of the Code and the Agreement.

Article 23.

This article prohibits discriminatory application of the taxes covered by the Agreement.

Paragraph 1 prohibits discrimination based solely on nationality. It provides that nationals of a Contracting State, wherever resident, shall not be taxed less favorably or subjected to more burdensome requirements connected with taxation, in the other Contracting State than nationals of that other State who are in the same circumstances. U.S. citizens who are not residents of the United States are not in the same circumstances as citizens of China who are not residents of the United States, because nonresident U.S. citizens generally are subject to U.S. tax on their worldwide income whereas nonresident aliens of the United States generally are subject to U.S. tax only on their U.S. income.

Paragraph 2 provides that a Contracting State may not impose more burdensome taxes or related requirements on a permanent establishment of an enterprise of the other Contracting State than it imposes on its own enterprises carrying on the same activities. However, when the permanent establishment is maintained by an individual resident of the other State, the State in which the permanent establishment is maintained is not obligated to grant to that individual the same personal allowances it grants to its own residents to reflect differing family responsibilities.

Paragraph 3 prohibits discrimination in the matter of deductions. Interest, royalties, and other disbursements by a resident of a Contracting State to a resident of the other Contracting State must be deductible for determining taxable profits in that other State under the same conditions as if they had been paid to a resident of the first-mentioned State. The term "other disbursements" is understood to include a reasonable allocation of executive and administrative expenses incurred for the benefit of a group of related enterprises.

Paragraph 4 requires that a Contracting State not impose more burdensome taxation on a subsidiary corporation owned by residents of the other State than it imposes on similar corporations which are locally owned.

Article 24.

This Article provides for cooperation between the competent authorities to resolve problems of double taxation.

Paragraph 1 provides that a taxpayer who considers that the actions of one or both of the Contracting States may result in taxation not in accordance with the Agreement may present his case to the competent authority of the Contracting State of which he is a resident or, in the case of claims concerning discrimination on the basis of nationality, to the competent authority of the Contracting State of which he is a national. In either case, the claim must be made within three years from the first notification of the action resulting in taxation not in accordance with the Agreement.

Paragraph 2 provides that the competent authority to which the case is presented, if it considers the objection to be justified and if it is not itself able to arrive at a solution, shall endeavor to resolve the case through consultation with the competent authority of the other Contracting State. Any agreement reached shall be implemented without regard to any statutory time limits of the Contracting States. Thus, if a Contracting State agrees that its tax was overstated, a refund of the excess tax paid will be made, even though the statute of limitations under domestic law may have expired. The waiver of the statute of limitations applies only for refunds and not for the imposition of additional taxes.

Paragraph 3 provides that the competent authorities shall endeavor to resolve by mutual agreement any difficulties or doubts which may arise in the interpretation or application of the Agreement. For example, the competent authorities may agree on the same allocation of income, deductions, credits, or allowances, on the same characterization of items of income, and on a common meaning of terms used in the Agreement. The competent authorities also may consult together to eliminate double taxation in cases not provided for in the Agreement. The authority to consider cases not covered in the Agreement is not a broad grant of authority to expand the scope of the Agreement, but is intended to permit the competent authorities to apply the principles of the Agreement to settle specific cases of double taxation which are not expressly addressed.

Paragraph 4 provides that the competent authorities may communicate with each other directly for the purpose of reaching agreements in accordance with this article.

Article 25.

This article provides for exchanges of information between the tax authorities of the two Contracting States to avoid double taxation and prevent fiscal evasion.

Paragraph 1 provides that the competent authorities shall exchange such information as is necessary for carrying out the provisions of the Agreement or of their domestic laws concerning taxes covered by the Agreement, in particular with the objective of preventing tax evasion. Such information may be provided whether or not the requested Contracting State has a tax interest in the case in question. It also provides assurances that information so exchanged will be protected in the same manner as information obtained under domestic laws with respect to secrecy and disclosure. Persons involved in the administration of taxes covered by the Agreement include legislative bodies involved in the administration of taxes and their agents such as, for example, the U.S. General Accounting Office. Information may be disclosed to such persons, subject to the limitations of this article and the domestic law of the respective Contracting State.

Paragraph 2 explains that the obligation undertaken in paragraph 1 to exchange information does not require a Contracting State to carry out measures contrary to the laws and administrative practice of either Contracting State, to supply information not obtainable under its laws or in the normal course of its administration, or to supply information which would disclose trade secrets or other information the disclosure of which would be contrary to public policy.

Article 26.

This article clarifies that the Agreement does not affect taxation privileges of diplomatic or consular officials under other special agreements or under international law.

Article 27.

The Agreement is subject to approval in each Contracting State according to its legal requirements. Each State will notify the other, in writing, through diplomatic channels when those requirements have been completed.

The Agreement enters into force on the thirtieth day after the date of the later of such notification. Once it enters into force, its provisions will take effect for income derived during taxable periods of the recipient beginning on or after January 1 of the year following the entry into force.

Article 28.

The Agreement remains in force indefinitely unless terminated by one of the Contracting States. Either Contracting State may terminate the Agreement after five years from the date on which it enters into force by giving at least six months prior notice through diplomatic channels prior to June 30. In that event, the Agreement will cease to have effect with respect to income derived during taxable years of the recipient beginning on or after January 1 following the termination date.

Protocol

A protocol accompanies and forms part of the Agreement.

The provisions of paragraphs 1 through 6 of the Protocol are discussed above in connection with Articles 1, 2, 3, 4 and 11 of the Agreement.

Paragraph 7 of the Protocol contains a protection against "treaty shopping." It provides that the competent authorities may through consultation deny the benefits of Articles 9, 10, and 11, concerning dividends, interest and royalities, to a company of a third country if that company becomes a resident of one of the Contracting States for the principal purpose of enjoying benefits under the Agreement. This consultation obligation is intended to benefit both governments. The denial of benefits requires consultation, but is not dependent on the prior agreement of the competent authorities.

This provision is stated in more general and limited terms than the corresponding provision in other recent U.S. tax treaties, not because of a lesser interest in the principle of limiting treaty benefits to residents of the other Contracting State, but because it is not anticipated that this Agreement will be used for treaty shopping purposes. In particular, Chinese currency and investment controls and their limited network of treaties make it unlikely that third country residents would use China as a conduit for investing in the United States.

Paragraph 8 confirms that the taxation of international transportation income is governed by the agreement of March 5, 1982 with respect to mutual exemption from taxation of transportation income of shipping and air transport enterprsies.

Exchange of letters

In letters signed at the same time as the rest of the Agreement, President Reagan and Premier Zhao confirm the understanding of the two governments with respect to the United States position on tax sparing credits. It is agreed that, if the United States amends its laws to authorizes such credits or grants such a credit in a tax treaty with another country, the Agreement will be amended to incorporate such a credit. The amended Agreement would be subject to ratification.

ARGENTINA

DEPARTMENT OF STATE
WASHINGTON
DECEMBER 30, 1987

Excellency:

I have the honor to refer to the agreement signed on July 20, 1950, to exempt from income tax, on a reciprocal basis, income derived from international operation of ships and aircraft. The Government of the United States proposes that the Government of the United States of America and the Government of the Argentine Republic modify the terms of the agreement. The terms of the modified agreement are as follows:

Article 1

For the purposes of this agreement:

1. (a) The term "U.S. tax" means the Federal income taxes imposed by the Internal Revenue Code, including the tax on gross income imposed by section 887.

(b) the term "Argentine tax" means:

- (i) the income tax (impuesto a las ganacias);
- (ii) the capital gains tax (impuesto a los beneficios de caracter eventual);
- (iii) the tax on capital of enterprises (impuesto al capital de las empresas);
- (iv) the tax on net worth (impuesto al patrimonio neto).

2. The term "Party" means the United States or Argentina, as the case may be.

3. The term "enterprise of a Party" means:

(a) in the case of an Argentine enterprise, enterprises owned by the Government of Argentina or a political subdivision or local authority thereof, individuals who are residents of Argentina and not citizens of the United States, or corporations or companies having their place of effective management in Argentina and not created under the laws of the United States.

(b) in the case of a United States enterprise, an enterprise owned by the Government of the United States—or a political subdivision of local authority thereof, individuals who are citizens or residents of the United States and not residents of Argentina, or companies created under the laws of the United States and not having their place of effective management in Argentina.

(c) it is understood that for a corporation to claim the benefits of this Agreement as an enterprise of a Party, it must satisfy the requirements of the law of the other Party designed to limit such benefits to corporations owned by residents of the first-mentioned Party.

4. The term "gross income" means all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and from the rental on a bareboat basis of ships or aircraft if the ships or aircraft are used in international transport or the rental income is incidental to income from the international operation of ships or aircraft. It also includes income from the rental of containers and related equipment used in international transport, and gains from the alienation of ships or aircraft or containers operated in internal transport, provided that such activity of rental or alienation is incidental to the international operation of ships or aircraft.

5. The term "competent authority" means:

(a) in the case of the United States, the Secretary of the Treasury or his delegate; and

(b) in the case of Argentina, the Ministry of Economy (Secretaria de Hacienda).

6. The term "international operation of ships or aircraft" means the

activity of transporting by ship or aircraft passengers, cargo, or mail and other directly related activities carried on by the owner, lessor or charterer of ships or aircraft except where such transport is solely between places in one Party.

Article 2

1. Gross income from the international operation of ships or aircraft derived by an enterprise of a Party shall be exempt from tax in the other Party.

2. Capital represented by ships or aircraft operated in international transport and by movable or immovable property pertaining exclusively to the operation of such ships or aircraft shall be taxable only in the Party in which the enterprise that operates such ships or aircraft is subject to tax in accordance with the preceding provisions.

3. The provisions of this article shall also apply to gross income from participation in a pool, a joint business, or an international operating agency.

Article 3

The competent authorities of the Parties shall endeavor to resolve by mutual agreement any difficulty or doubt arising as to the interpretation and application of this Agreement.

Article 4

The competent authorities of the Parties will endeavor to ensure that the tax benefits provided in this Agreement are not enjoyed by enterprises of third Parties.

Article 5

The Parties shall notify each other through diplomatic channels when their respective constitutional requirements for the entry into force of this Agreement have been satisfied. The Agreement shall enter into force on the date of the later of these notifications and shall have effect with respect to taxable years beginning on or after January 1, 1987. The Agreement shall be applied provisionally as of the date of signature.

Article 6

This agreement may be terminated by either Party giving written notice through diplomatic channels.

The Government of the United States of America considers that this note, together with your Government's reply note confirming that the Government of Argentine Republic agrees to these terms, constitutes an agreement between the two Governments modifying the agreement of July 20, 1950.

Accept, Excellency, the renewed assurances of my highest consideration.

Embassy
of the
Argentine Republic

Washington, D.C. 30 December 1987

Mr. Secretary of State:

I have the honor of replying to Your Excellency's note of 30 December 1987, which states:

Excellency:

I have the honor to refer to the agreement signed on July 20, 1950 to exempt from income tax, on a reciprocal basis, income derived from international operation of ships and aircraft. The Government of the United States proposes that the Government of the United States of America and the Government of the Argentine Republic modify the terms of the agreement. The terms of the modified agreement are as follows:

Article 1

For the purposes of this agreement:

(a) The term "U.S. tax" means the Federal income taxes imposed by the Internal Revenue Code, including the tax on gross income imposed by section 887.

(b) the term "Argentine tax" means:

- (i) the income tax (impuesto a las ganancias);
- (ii) the capital gains tax (impuesto a los beneficios de caracter eventual);
- (iii) the tax on capital of enterprises (impuesto al capital de las empresas);
- (iv) the tax on net worth (impuesto al patrimonio neto).

2. The term "Party" means the United States or Argentina, as the case may be.

3. The term "enterprise of a Party" means:

(a) in the case of an Argentine enterprise, enterprises owned by the Government of Argentina or a political subdivision or local authority thereof, individuals who are residents of Argentina and not citizens of the United States, or corporations or companies having their place of effective management in Argentina and not created under the laws of the United States.

(b) in the case of a United States enterprise, an enterprise owned by the Government of the United States or a political subdivision or local authority thereof, individuals who are citizens or residents of the United States and not residents of Argentina, or companies created under the laws of the United States and not having their place of effective management in Argentina.

(c) it is understood that for a corporation to claim the benefits of this Agreement as an enterprise of a Party, it must satisfy the requirements of the law of the other Party designed to limit such benefits to corporations owned by residents of the first-mentioned Party.

4. The term "gross income" means all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a ful (time or voyage) basis and from the rental on a bareboat basis of ships or aircraft if the ships or aircraft are used in international transport or the rental income is incidental to income from the international operation of ships or aircraft. It also includes income from the rental of containers and related equipment used in international transport, and gains from the alienation of ships or aircraft or containers operated in international transport, provided that such activity of rental or alienation is incidental to the international operation of ships or aircraft.

5. The term "competent authority" means:

(a) in the case of the United States, the Secretary of the Treasury or his delegate; and

(b) in the case of Argentina, the Ministry of Economy (Secretaria de Hacienda).

(6) The term "international operation of ships or aircraft" means

the activity of transporting by ship or aircraft passengers, cargo, or mail and other directly related activities carried on by the owner, lessor or charterer of ships or aircraft except where such transport is solely between places in one Party.

Article 2

1. Gross income from the international operation of ships or aircraft derived by an enterprise of a Party shall be exempt from tax in the other Party.

2. Capital represented by ships or aircraft operated in international transport and by movable or immovable property pertaining exclusively to the operation of such ships or aircraft shall be taxable only in the Party in which the enterprise that operates such ships or aircraft is subject to tax in accordance with the preceding provisions.

3. The provisions of this article shall also apply to gross income from participation in a pool, a joint business, or an international operating agency.

Article 3

The competent authorities of the Parties shall endeavor to resolve by mutual agreement any difficulty or doubt arising as to the interpretation and application of this Agreement.

Article 4

The competent authorities of the Parties will endeavor to ensure that the tax benefits provided in this Agreement are not enjoyed by enterprises of third Parties.

Article 5

The Parties shall notify each other through diplomatic channels when their respective constitutional requirements for the entry into force of this Agreement have been satisfied. The Agreement shall enter into force on the date of the later of these notifications and shall have effect with respect to taxable years beginning on or after January 1, 1987. The Agreement shall be applied provisionally as of the date of signature.

Article 6

This agreement may be terminated by either Party giving written notice through diplomatic channels.

The Government of the United States of America considers that this note, together with your Government's reply note confirming that the Government of Argentine Republic agrees to these terms, constitutes an agreement between the two Governments modifying the agreement of July 20, 1950.

Accept, Excellency, the renewed assurances of my highest consideration. Signed for the Acting Secretary of State, William B. Milan, Deputy Assistant Secretary for International Finance and Development."

In expressing to Your Excellency the agreement of my Government with the provisions of the note quoted above, I have the honor to inform you that that note and the present note constitute an agreement between our two Governments which modifies the Agreement of July 20, 1950.

Greetings to Your Excellency with my highest and most distinguished consideration.

Enrique J. A. Candioti,
Ambassador.

BAHAMAS

Department of State
Washington,D.C.
June 26, 1987

The Department of State acknowledges receipt of note No. 52/87, dated May 18, 1987, from the Embassy of the Commonwealth of The Bahamas regarding the reciprocal exemption from income tax of income derived from the international operation of ships and aircraft.

Through the above-mentioned note, the Government of Bahamas, conveyed its favorable consideration of the Department of State's December 5, 1986 proposal for an exchange of notes establishing a reciprocal exemption of shipping and aircraft income tax. The Department of State proposes to the Embassy of the Commonwealth of The Bahamas that the Government of the United States of America and the Government of the Commonwealth of The Bahamas now conclude an agreement to exempt from income tax, on a reciprocal basis, income derived by residents of the other country from the international operation of ships and aircraft. The terms of the agreement are as follows:

The Government of the United States of America, in accordance with sections 872(b) and 883(a) of the Internal Revenue Code, agrees to exempt from tax gross income derived from the international operation of ships or aircraft by individuals who are residents of the Commonwealth of The Bahamas (other than U.S. citizens) and corporations organized in the Commonwealth of The Bahamas. This exemption is granted on the basis of equivalent exemptions granted by the Government of the Commonwealth of The Bahamas to citizens of the United States (who are not residents of the Commonwealth of The Bahamas) and to corporations organized in the United States (which are not subject to tax by the Government of the Commonwealth of The Bahamas on the basis of residence).

In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(1) more than fifty percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of the Commonwealth of The Bahamas or of another country which grants a reciprocal exemption to U.S. citizens and corporations; or

(2) the corporation's stock is primarily and regularly traded on an established securities market in the Commonwealth of The Bahamas, or is wholly owned by a corporation whose stock is so traded and which is also organized in the Commonwealth of The Bahamas. For purposes of the exemption from U.S. tax, subparagraph (1) will be considered to be satisfied if the corporation is a "controlled foreign corporation" under the Internal Revenue Code.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

The Department of State considers that this note, together with the Embassy's reply note confirming that the Government of the Commonwealth of The Bahamas agrees to these terms, constitutes an agreement between the two Governments. This agreement shall enter into force on the date of the Embassy's reply note and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Department of State calls the Government of the Commonwealth of The Bahamas' attention to a slight change between the above-proposed agreement and the agreement set out in the December 5, 1986 proposal. In the conditions necessary for the exemption to apply to a corporation, the ownership requirement concerning "fifty percent or more of the value of the corporation's stock" has been changed to "more than fifty percent of the corporation's stock." This change is necessary to make the agreement conform to revelent U.S. legislation.

Embassy of the Commonwealth
of the Bahamas
Washington, D.C.
16 July, 1987

The Embassy of the Commonwealth of The Bahamas acknowledges receipt of a note dated 26 June, 1987 from the Department of State of the United States of America regarding the reciprocal exemption from income tax of income derived from the international operations of ships and aircraft.

The Embassy of the Commonwealth of The Bahamas wishes to advise that the Government of the Commonwealth of The Bahamas is in agreement with the terms set out in the Department's Note under reference and confirms that this reply Note constitutes an agreement between the two Governments establishing a reciprocal exemption of shipping and aircraft income tax. This agreement shall enter into effect on today's date and shall have effect with respect to taxable years beginning on or after January 1, 1987.

The Embassy of the Commonwealth of The Bahamas avails itself of the opportunity to renew to the Department of State of the United States of America the assurances of its highest consideration.

BELGIUM

Embassy of Belgium
Washington, D.C.
October 14, 1987

The Department of State proposes to the Embassy of Belgium that the Government of Belgium conclude an agreement replacing the Arrangement of January 28, 1936, and the Agreement of July 18, 1953, to exempt from income tax, on a reciprocal basis, income derived by residents of the other country from the international operation of ships and aircraft. The terms of the agreement are as follows:

The Government of the United States of America, in accordance with sections 872(b) and 883(a) of the Internal Revenue Code, agrees to exempt from tax gross income derived from the international operation of ships or aircraft by residents of Belgium (other than individuals who are U.S. citizens). This exemption is granted on the basis of equivalent exemptions granted by Belgium.

In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(1) more than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of Belgium or of another country which grants a reciprocal exemption to U.S. citizens and corporations; or

(2) the corporation's stock is primarily and regularly traded on a recognized stock exchange in Belgium or is wholly owned by a corporation whose stock is so traded and which is also a resident of Belgium.

For the purposes of subparagraph (1), the Government of Belgium shall be treated as an individual resident of Belgium.

For purposes of the exemption from U.S. tax, subparagraph (1) will be considered to be satisfied if the corporation is a "controlled foreign corporation" under the Internal Revenue Code.

The Department of State considers that this note, together with the Embassy's reply note confirming that the Government of Belgium agrees to these terms, constitutes an agreement replacing the Arrangement of January 28, 1936, and the Agreement of July 18, 1953. This agreement shall enter into force on the date of the Embassy's reply note and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

Department of State
Washington, D.C.

The Embassy of Belgium presents its compliments to the Department of State and has the honour to acknowledge receipt of the Department's note of October 14, 1987, proposing the terms of a reciprocal exemption from income tax of income derived from the international operation of ships and aircraft.

The Government of Belgium in accordance with Article 141, 5*, of the Income Tax Code, agrees to exempt from tax income derived from the international operation of ships or aircraft by U.S. residents or by U.S. citizens, who are not residents of Belgium.

In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(1) more than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are citizens of United States or of another country which grants a reciprocal exemption to Belgium residents and corporations; or

(2) the corporation's stock is primarily and regularly traded on an

established securities market in the United States, or is wholly owned by a corporation whose stock is so traded and which is also organized in the United States. For the purposes of subparagraph (1), the Government of the United States shall be treated as an individual resident of the United States.

The Embassy is pleased to confirm that the Department of State's note and this reply note constitute an agreement replacing the Arrangement of January 28, 1936, and the Agreement of July 18, 1953, which shall enter into force on today's date and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Embassy of Belgium takes this opportunity to renew to the Department of State the assurances of its highest consideration.

BOLIVIA

Department of State
Washington, D.C.
July 21, 1987

The Department of State proposes to the Embassy of Bolivia that the Government of the United States of America and the Government of Bolivia conclude an agreement to exempt from income tax, on a reciprocal basis, income derived by residents of the other country from the international operation of ships and aircraft. The terms of the agreement are as follows:

The Government of the United States of America, in accordance with sections 872(b) and 883(a) of the Internal Revenue Code, agrees to exempt from tax gross income derived from the international operation of ships or aircraft by individuals who are residents of Bolivia (other than U.S. citizens) and corporations organized in Bolivia. This exemption is granted on the basis of equivalent exemptions granted by Bolivia to citizens of the United States (who are not residents of Bolivia) and to corporations organized in the United States (which are not subject to tax by Bolivia on the basis on residence).

In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(1) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of Bolivia or of another country which grants a reciprocal exemption to U.S. citizens and corporations; or

(2) the corporation's stock is primarily and regularly traded on an established securities market in Bolivia, or is wholly owned by a corporation whose stock is so traded and which is also organized in Bolivia.

For purposes of the exemption from U.S. tax, subparagraph (1) will be considered to be satisfied if the coroporation is a "controlled foreign corporation" under the Internal Revenue Code.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

The Department of State considers that this note, together with the Embassy's reply note confirming that the Government of Bolivia agrees to these terms, constitutes an agreement between the two Governments. This agreement shall enter into force on the date of the Embassy's reply note and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

For use by the Government of Bolivia, a draft reply note is enclosed.

Enclosure:
As stated

Embassy of Bolivia
Washington, D.C.
November 23, 1987

The Embassy of Bolivia presents its compliments to the Department of State and has the honor to acknowledge receipt of the Department's note of July 21, 1987, proposing the terms of a reciprocal exemption from income tax of income derived from the international operation of ships and aircraft.

The Government of Bolivia agrees to exempt from tax gross income derived from the international operation of ships or aircraft by U.S. citizens (who are not residents of Bolivia) and corporations organized in the United States (other than corporations which are subject to tax by Bolivia on the basis of residence).

In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(1) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are citizens of United States or of another country which grants a reciprocal exemption to Bolivian residents and corporations; or

(2) the corporation's stock is primarily and regularly traded on an established securities market in the United States, or is wholly owned by a corporation whose stock is so traded and which is also organized in the United States.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

The Embassy is pleased to confirm that the Department of State's note and this reply note constitute an agreement between the two Governments, which shall enter into force on November 23, 1987, and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Embassy of Bolivia takes this opportunity to renew to the Department of State the assurances of its highest consideration.

COLOMBIA

His Excellency
Coronel Julio Londono
Minister of Foreign Relations
Bogota, D.E.

October 16, 1987

Excellency:

I have the honor to propose to your Excellency that our two Governments conclude an Agreement to exempt from income tax, on a reciprocal basis, income derived by residents of the other country from the international operation of ships and aircraft. The terms of the Agreement are as follows:

The Government of the United States of America, in accordance with Sections 872(B) and 883(A) of the Internal Revenue Code, agrees to exempt from tax gross income derived from the international operations of ships or aircraft by individuals who are residents of Colombia (other than U.S. citizens) and corporations organized in Colombia. This exemption is granted on the basis of equivalent exemptions granted by Colombia to citizens of the United States (who are not residents of Colombia) and to corporations organized in the United States (which are not subject to tax by Colombia on the basis of residence).

In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(1) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of Colombia or of another country which grants a reciprocal exemption to U.S. citizens and corporations; or

(2) The corporation's stock is primarily and regularly traded on an established securities market in Colombia, or is wholly owned by a corporation whose stock is so traded and which is also organized in Colombia.

For purposes of Subparagraph 1, the Government of Colombia will be treated as an individual resident of Colombia. For purposes of the exemption from U.S. tax, Subparagraph 1 will be considered to be satisfied if the corporation is a "controlled foreign corporation" under the Internal Revenue Code.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

Either Government may terminate this Agreement by giving written notice of termination through diplomatic channels.

The Government of the United States of America considers that this note, together with the Ministry's reply note confirming that the Government of Colombia agrees to these terms, constitutes an Agreement amending the Agreement of August 1, 1961. This Agreement shall enter into force on the date on which the Government of Colombia notifies the Government of the United States that this exchange of notes has been approved by the Congress of Colombia and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Accept, Excellency, the renewed assurances of my highest consideration.

Charles A. Gillespie, Jr.,
Ambassador.

EXCELLENCY
CHARLES A. GILLESPIE
Ambassador of the United
States of America
Bogota

October 16, 1987

Excellency:

I have the honor to acknowledge receipt of your note of today's date proposing the terms of a reciprocal exemption from income tax of income derived from the international operation of ships and aircraft.

The Government of Colombia agrees to exempt from tax gross income derived from the international operation of ships and aircraft by U.S. citizens (who are not residents of Colombia) and corporations organized in the United States (other than corporations which are subject to tax by Colombia) on the basis of residence.

(in the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(1) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are citizens of the United States or of another country which grants a reciprocal exemption to colombia, residents and corporations; or

(2) the corporation's stock is primarily and regularly traded on an established securities market in the United States, or is wholly owned by a corporation whose stock is so traded and which is also organized in the United States.)

Gross income includes all income derived from the international operation of ships and aircraft, including income from the rental of ships and aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships and aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

Either government may terminate this agreement by giving written notice of termination through diplomatic channels.

I am pleased to confirm that the Embassy's Note 803 and this reply constitute an agreement amending the Agreement of August 1, 1961, which shall enter into force on today's date and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Please accept, Excellency, the assurances of my highest consideration.

EXCELLENCY
CHARLES A. GILLESPIE
Ambassador of the United
States of America.

Bogotá

JULIO LONDONO
PAREDES
Minister of Foreign
Affairs of Colombia

DENMARK

Department of State
Washington, D.C.
July 6, 1987

The Department of State proposes to the Embassy of Denmark that the Government of the United States of America and the Government of the Kingdom of Denmark conclude an agreement amending the Exchange of Notes between the Government of the United States of America and the Government of the Kingdom of Denmark relating to relief from double income tax on shipping profits, signed at Washington, May 22, August 9 and 18, October 24, 25 and 28, and December 5 and 6, 1922, to exempt from income tax, on a reciprocal basis, income derived by residents of the other country from the international operation of ships and aircraft. The terms of the agreement are as follows:

The Government of the United States of America, in accordance with sections 872(b) and 883(a) of the Internal Revenue Code, agrees to exempt from tax gross income derived from the international operation of ships or aircraft by individuals who are residents of Denmark (other than U.S. citizens) and corporations organized in Denmark. This exemption is granted on the basis of equivalent exemptions granted by Denmark to citizens of the United States (who are not residents of Denmark) and to corporations organized in the United States (which are not subject to tax by Denmark on the basis of residence).

In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(1) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of Denmark or of another country which grants a reciprocal exemption to U.S. citizens and corporations; or

(2) the corporation's stock is primarily and regularly traded on an established securities market in Denmark, or is wholly owned by a corporation whose stock is so traded and which is also organized in Denmark.

For purposes of the exemption from U.S. tax, subparagraph (1) will be considered to be satisfied if the corporation is a "controlled foreign corporation" under the Internal Revenue Code.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

The Department of State considers that this note, together with the Embassy's reply note confirming that the Government of the Kingdom of Denmark agrees to these terms, constitutes an agreement amending the Exchange of Notes between the Government of the United States of America and the Government of the Kingdom of Denmark relating to relief from double income tax on shipping profits, signed at Washington, May 22, August 9 and 18, October 24, 25 and 28, and December 5 and 6, 1922. This agreement shall not affect the provisions of the Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, dated May 6, 1948. This agreement shall enter into force on the date of the Embassy's reply note and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

DANISH EMBASSY
Washington, D.C.
July 6, 1987

The Embassy of Denmark presents its compliments to the Department of State and has the honor to acknowledge receipt of the Department's note of today's date proposing the terms of a reciprocal exemption from income tax of income derived from the international operation of ships and aircraft.

The Government of the Kingdom of Denmark agrees to exempt from tax gross income derived from the international operation of ships or aircraft by U.S. citizens (who are not residents of Denmark) and corporations organized in the United States (other than corporations which are subject to tax by Denmark on the basis of residence).

In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(1) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are citizens of the United States or of another country which grants a reciprocal exemption to Danish residents and corporations; or

(2) the corporation's stock is primarily and regularly traded on an established securities market in the United States, or is wholly owned by a corporation whose stock is so traded and which is also organized in the United States.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

The Embassy is pleased to confirm that the Department of State's note and this reply note constitute an agreement amending the Exchange of Notes between the Government of the United States of America and the Government of the Kingdom of Denmark relating to relief from double income tax on shipping profits, signed at Washington, May 22, August 9 and 18, October 24, 25, and 28, and December 5 and 6, 1922. This agreement shall not affect the provisions of the Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, dated May 6, 1948. This agreement shall enter into force on today's date and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Embassy of Denmark take this opportunity to renew to the Department of State the assurances of its highest consideration.

Washington, D.C., July 6, 1987.

EL SALVADOR

Embassy of the United States
San Salvador
December 17, 1987

The Embassy of the United States of America presents its compliments to the Ministry of Foreign Affairs of El Salvador and has the honor to propose that the two governments conclude an agreement to exempt from income tax, on a reciprocal basis, income derived by residents of the other country from the operation of aircraft. The terms of the agreement are as follows:

The Government of the United States of America, in accordance with sections 872(B) and 883(A) of the Internal Revenue Code, agrees to exempt from the taxes imposed by Subtitle A of the Internal Revenue Code gross income derived from the operation of aircraft by individuals who are residents of El Salvador (other than U.S. citizens) and corporations organized in El Salvador. This exemption is granted on the basis of equivalent exemptions granted by El Salvador to citizens of the United States (who are not residents of El Salvador) and to corporations organized in the United States.

In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(1) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of El Salvador or of another country which grants a reciprocal exemption to U.S. citizens and corporations; or

(2) The corporation's stock is primarily and regularly trade on an established securities market in El Salvador or is wholly owned (directly or indirectly) by a corporation whose stock is so traded and which is also organized in El Salvador.

For purposes of the exemption from U.S. tax, subparagraph (1) will be considered to be satisfied if the corporation is a "controlled foreign corporation" under the Internal Revenue Code.

Gross income means all income derived from the operation of aircraft, and all income from rental of aircraft, maintenance of aircraft, and gains from the alienation of aircraft, if the aircraft is operated in, or rented for use in, international traffic, or if such income is incidental to income from the international operation, or rental for international operation, of aircraft. It also includes income from the rental of containers and related equipment which is incidental to income from the international operation of aircraft.

The Embassy of the United States of America considers that this note, together with the Ministry's reply note confirming that the Government of El Salvador agrees to these terms, constitutes an agreement between the two governments. This agreement shall enter into force on the date of the Ministry's reply note and shall have effect with respect to the taxable years beginning on or after January 1, 1987.

Either government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Embassy of the United States of America takes this opportunity to renew to the Ministry of Foreign Affairs of El Salvador the assurances of its highest consideration.

Ministry of Foreign Relations
Republic of El Salvador, C.A.

San Salvador
December 17, 1987

[Unofficial Translation]

The Ministry of Foreign Relations of the Republic of El Salvador presents its compliments to the Honorable Embassy of the United States of America, on the occasion of acknowledging the receipt of its note verbal No. 722, dated December 17, 1987, which proposes to the Government of El Salvador an Agreement to exempt from income tax, on a reciprocal basis, income derived by residents of the other country from the operation of aircraft.

The Ministry of Foreign Relations informs the Honorable Mission of the full acceptance of the Government of the Republic of El Salvador, of the provisions of the referenced Agreement, for which the referenced note and the present note constitute an Agreement.

The Ministry of Foreign Relations takes the opportunity to renew to the Honorable Embassy of the United States of America the assurances of its most high and distinguished consideration.

LIBERIA

Embassy of the United States of America
Monrovia
October 7, 1987

THE EMBASSY OF THE UNITED STATES OF AMERICA presents its compliments to the Ministry of Foreign Affairs of the Republic of Liberia and has the honor to propose that the two governments conclude an agreement to exempt from income tax, on a reciprocal basis, income derived by residents of the other country from the international operation of ships and aircraft. The terms of the agreement are as follows:

The Government of the United States of America, in accordance with sections 872(B) and 883(A) of the Internal Revenue Code, agrees to exempt from tax gross income derived from the international operation of ships or aircraft by Liberian persons, including Liberian residents and/or corporations organized in the Republic of Liberia. This exemption is granted on the basis of equivalent exemptions granted by the Republic of Liberia to United States persons and to corporations organized in the United States.

In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(1) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by indi-

viduals who are residents of the Republic of Liberia or of another country which grants a reciprocal exemption to U.S. citizens and corporations; or

(2) The corporation's stock is primarily and regularly traded on an established securities market in the Republic of Liberia, or is wholly owned, directly or indirectly, by a corporation whose stock is so traded and which is also organized in the Republic of Liberia.

For purposes of Subparagraph 1, the Government of the Republic of Liberia will be treated as an individual resident of the Republic of Liberia. For purposes of the exemption from U.S. tax, subparagraph (1) will be considered to be satisfied if the corporation is a "controlled foreign corporation" under the Internal Revenue Code.

Gross income includes all income derived from the international operation or chartering of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment, which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport and income from the disposition of ships or aircraft which is incidental to other income referred to in this paragraph.

The Embassy of the United States of America considers that this note, together with the Ministry's reply note confirming that the Government of the Republic of Liberia to these terms, constitutes an agreement amending the agreement of July 1 and August 11, 1982. This agreement shall enter into force on the date of the Ministry's reply note and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Embassy of the United States of America takes this opportunity to renew to the Ministry of Foreign Affairs of the Republic of Liberia the assurances of its highest consideration.

Ministry of Foreign Affairs
Monrovia, Liberia
October 23, 1987

The Ministry of Foreign Affairs of the Republic of Liberia presents its compliments to the Embassy of the United States of America and has the honour to acknowledge receipt of the latter's Note No. 281 of 7 October 1987 proposing the terms of a reciprocal exemption from income tax of income derived from the international operation of ships and aircraft.

The Government of the Republic of Liberia agrees to exempt from tax gross income derived from the international operation of ships or aircraft by U.S. persons, including U.S. citizens and/or Corporations organized in the United States.

Gross income includes all income derived from the international operation, chartering or disposition of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

The Ministry of Foreign Affairs is pleased to confirm that the Embassy's Note and this Reply Note constitute an Agreement amending the Agreement of July 1 and August 11, 1982, which shall enter into force on today's date and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Ministry of Foreign Affairs of the Republic of Liberia takes this opportunity to renew to the Embassy of the United States of America the assurances of its high consideration and esteem.

SINGAPORE

Ministry of Foreign Affairs of the Republic of Singapore

February 11, 1988

The Embassy of the United States of America presents its compliments to the Ministry of Foreign Affairs of the Republic of Singapore and has the honor to inform the Ministry that the Embassy wishes to replace the text of its Note No. 425/87 dated December 24, 1987, with the revised language below. This Note, therefore, proposes that the two Governments conclude an agreement to exempt from income tax, on a reciprocal basis, income derived by residents of the other country from the international operation of aircraft. The terms of the agreement are as follows:

The Government of the United States of America, in accordance with sections 872(b) and 883(a) of the Internal Revenue Code, agrees to exempt from tax gross income derived from the international operation of aircraft by individuals who are residents of the Republic of Singapore (other than U.S. citizens) and corporations which are controlled and managed in the Republic of Singapore (other than corporations organized in the United States). This exemption is granted on the basis of equivalent exemptions granted by the Republic of Singapore to citizens of the United States (who are not residents of the Republic of Singapore) and to corporations organized in the United States (which are not subject to tax by the Republic of Singapore on the basis of residence).

In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(I) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of the Republic of Singapore or of another country which grants a reciprocal exemption to U.S. citizens and corporations; or

(II) The corporation's stock is primarily and regularly traded on an established securities market in the Republic of Singapore, or is wholly-owned by a corporation whose stock is so traded and which is also organized in the Republic of Singapore.

For the purpose of sub-paragraph (I), the Government of the Republic of Singapore will be treated as an individual resident of the Republic of Singapore. For purposes of the exemption from U.S. tax, sub-paragraph (I) will be considered to be satisfied if the corporation is a "controlled foreign corporation" under the Internal Revenue Code.

Gross income includes all income derived from the operation of aircraft, including:

(I) Income from the rental of aircraft used in international transport on a full (time or voyage) or bareboat basis;

(II) Income from the rental of containers and related equipment used in international transport which is incidental to income from the international operation of aircraft;

(III) Income from the participation in air transport pools which engage in international operation of aircraft; and

(IV) Gains from the alienation of aircraft by a person whose predominant activity is the international operation of aircraft.

The Embassy of the United States of America considers that this note, together with the Ministry's reply note confirming that the Government of the Republic of Singapore agrees to these terms, constitutes an agreement amending the agreement of 30 September 1985. This agreement shall enter into force on the date of the Ministry's reply note and shall have effect with respect to taxable years beginning on or after 1 January 1987.

If any difficulty or doubt as to the interpretation or application of this agreement should arise, the competent authorities of the two countries shall seek to resolve such difficulty or doubt by mutual agreement. For this purpose, the competent authorities are:

(A) In the United States, the Secretary of the Treasury or his authorized representative; and

(B) In Singapore, the Minister for Finance or his authorized representative.

Either government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Embassy of the United States of America takes this opportunity to renew to the Ministry of Foreign Affairs of the Republic of Singapore the assurances of its highest consideration.

Embassy of the United States of America
Singapore

March 24, 1988

The Ministry of Foreign Affairs of the Republic of Singapore presents its compliments to the Embassy of the United States of America and has the honor to acknowledge receipt of the Embassy's note No. 064/88, dated 11 February 1988, proposing the terms of the reciprocal exemption from income tax of income derived from the international operation of aircraft.

The Government of the Republic of Singapore agrees to exempt from tax gross income derived from the international operation of aircraft by U.S. citizens (who are not residents of the Republic of Singapore) and corporations organized in the United States (other than corporations which are subject to tax by the Republic of Singapore on the basis of residence). This exemption is granted on the basis of equivalent exemptions granted by the United States to individuals who are residents of the Republic of Singapore (other than U.S. citizens) and corporations which are controlled and managed in the Republic of Singapore (other than corporations organized in the United States).

In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(I) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are citizens of the United States or of another country which grants a reciprocal exemption to residents (both individuals and corporations) of the Republic of Singapore; or

(II) The corporation's stock is primarily and regularly traded on an established securities market in the United States, or is wholly-owned by a corporation whose stock is so traded and which is also organized in the United States. For the purposes of sub-paragraph (I), the Government of the United States of America will be treated as an individual resident of the United States of America.

Gross income includes all income derived from the operation of aircraft, including:

(I) Income from the rental of aircraft used in international transport on a full (time or voyage) or bareboat basis;

(II) Income from the rental of containers and related equipment used in international transport which is incidental to income from the international operation of aircraft;

(III) Income from the participation in air transport pools which engage in international operation of aircraft; and

(IV) Gains from the alienation of aircraft by a person whose predominant activity is the international operation of aircraft.

The Ministry of Foreign Affairs is pleased to confirm that the Embassy's note and this reply note constitute an agreement amending the agreement of 30 September 1985. This agreement shall enter into force on the date of the Ministry's reply note and shall have effect with respect to taxable years beginning on or after 1 January 1987.

If any difficulty or doubt as to the interpretation or application of this agreement should arise, the competent authorities of the two countries shall seek to resolve such difficulty or doubt by mutual agreement. For this purpose, the competent authorities are:

(A) In the United States, the Secretary of the Treasury or his authorized representative; and

(B) In Singapore, the Minister for Finance or his authorized representative.

Either government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Ministry of Foreign Affairs of the Republic of Singapore avails itself of this opportunity to renew to the Embassy of the United States of America the assurances of its highest consideration.

SWEDEN

[Note of December 3, 1986, not published]

Department of State
Washington, D.C.

May 8, 1987

The Swedish Embassy presents its compliments to the Department of State and has the honor to refer to the Department's note of December 3, 1986, regarding an amendment to the exchange of notes between the Government of Sweden and the Government of the United States of America relating to relief from double income tax on shipping profits, signed at Washington, March 31, 1938.

The Embassy wishes to inform the Department of State that the Government of Sweden accepts the proposal to amend the existing arrangement in the manner proposed by the Department with, however, the following amendment:

The sentence "It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport." is replaced by "It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport if it is an occasional source of income for an enterprise engaged in the international operation of ships or aircraft."

The Government of Sweden desires to make the exchange of notes, with the indicated amendment, as soon as possible.

The Swedish Embassy avails itself of this opportunity to renew to the Department of State the assurances of its highest consideration.

Swedish Embassy
Washington, D.C.

June 26, 1987

The Department of State acknowledges receipt of note No. 33, dated May 8, 1987, from the Embassy of Sweden.

The Department of State proposes to the Embassy of Sweden that the Government of the United States of America and the Government of Sweden conclude an agreement amending the agreement of March 31, 1938 to exempt from income tax, on a reciprocal basis, income derived by residents of the other country from the international operation of ships and aircraft. The terms of the agreement are as follows:

The Government of the United States of America, in accordance with sections 872(b) and 883(a) of the Internal Revenue Code, agrees to exempt from tax gross income derived from the international operation of ships or aircraft by individuals who are residents of Sweden (other than U.S. citizens) and corporations organized in Sweden. This exemption is granted on the basis of equivalent exemptions granted by Sweden to citizens of the United States (who are not residents of Sweden) and to corporations organized in the United States (which are not subject to tax by Sweden on the basis of residence).

In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(1) more than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of Sweden or of another country which grants a reciprocal exemption to U.S. citizens and corporations; or

(2) the corporation's stock is primarily and regularly traded on an established securities market in Sweden, or is wholly owned by a corporation whose stock is so traded and which is also organized in Sweden.

For purposes of the exemption from U.S. tax, subparagraph (1) will be considered to be satisfied if the corporation is a "controlled foreign corporation" under the Internal Revenue Code.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport if it is an occasional source of income for an enterprise engaged in the international operation of ships or aircraft.

The Department of State considers that this note, together with the Embassy's reply note confirming that the Government of Sweden agrees to these terms, constitutes an agreement amending the agreement of March 31, 1938. This agreement shall enter into force on the date of the Embassy's reply note and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

Department of State
Washington, D.C.

July 24, 1987

The Embassy of Sweden presents its compliments to the Department of State and has the honor to acknowledge receipt of the Department's note of June 26, 1987, proposing the terms of a reciprocal exemption from income tax of income derived from the international operation of ships and aircraft.

The Government of Sweden agrees to exempt from tax gross income derived from the international operation of ships or aircraft by U.S. citizens (who are not residents of Sweden) and corporations organized in the United States (other than corporations which are subject to tax by Sweden on the basis of residence).

In the case of a corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(1) 50 percent or more of the value of the corporation's stock is owned, directly or indirectly, by individuals who are citizens of United States or of another country which grants a reciprocal exemption to Swedish residents and corporations; or

(2) the corporation's stock is primarily and regularly traded on an established securities market in the United States, or is wholly owned by a corporation whose stock is so traded and which is also organized in the United States.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport if it is an occasional source of income from an enterprise engaged in the international operation of ships or aircraft.

The Embassy is pleased to confirm that the Department of State's note and this reply note constitute an agreement amending the agreement of Sweden, which shall enter into force on today's date and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Embassy of Sweden takes this opportunity to renew to the Department of State the assurances of its highest consideration.

VENEZUELA

AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE REPUBLIC OF VENEZUELA FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO SHIPPING AND AIR TRANSPORT

The Government of the United States of America and the Government of the Republic of Venezuela, desiring to conclude an agreement for the avoidance of double taxation in respect of profits and income from the international operation of ships and aircraft, and having examined and verified the reciprocity of legal treatment concerning the taxation of such income, have agreed as follows:

Article 1

For the purposes of this agreement:

1. (a) The term "U.S. tax" means the Federal income taxes imposed by the Internal Revenue Code, including the tax on gross income imposed by section 887.

(b) The term "Venezuelan tax" means the Tax on Income (Impuesto sobrre la Renta).

2. The term "Contracting State" means the United States or Venezuela, as the case may be.

3. The term "enterprise of a Contracting State" means:

(a) in the case of a Venezuelan enterprise, enterprises owned by the Government of Venezuela, Venezuelan public entities, whether national or local in character, and individuals who are residents of Venezuela for tax purposes and not citizens of the United States, or by corporations or companies created and organized under the laws of Venezuela and having their seat of effective management in Venezuela.

(b) in the case of a United States enterprise, an enterprise owned by the Government of the United States or a political subdivision or local authority thereof, or by individuals who are citizens or residents of the United States and not residents of Venezuela, or by companies created under the laws of the United States.

(c) It is understood that for a corporation to claim the benefits of this Agreement as an enterprise of a Contracting State, it must satisfy the requirements of the law of the other Contracting State designed to limit such benefits to corporations owned by residents of the first-mentioned State.

4. The term "profits and income" means all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis. It also includes income from the rental on a bareboat basis of ships and aircraft used in international transport, income from the rental of containers and related equipment used in international transport, and gains from the alienation of ships, aircraft or containers operated in international transport, provided that such activity of rental or alienation is incidental to the international operation of ships or aircraft.

5. The term "competent authority" means:

(a) in the case of the United States, the Secretary of the Treasury or his delegate; and

(b) in the case of Venezuela, the General Directorate of Revenues of the Ministry of Finance.

6. The term "international operation of ships or aircraft" means the activity of transporting by ship or aircraft passengers, cargo, or mail and other directly related activities carried on by the owner, lessor or charterer of ships or aircraft.

Article 2

1. Subject to the provision of Article 3 of this Agreement, profits and income from the international operation of ships or aircraft derived by an enterprise of a Contracting State shall be exempt from tax in the other Contracting State.

2. The provisions of this article shall also apply to profits or income from participation in a pool, a joint business, or an international operating agency.

Article 3

The exemption provided by Article 2 shall apply to an enterprise of a Contracting State which serves a port or an airport situated in the territory of the other Contracting State.

Article 4

The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulty or doubt arising as to the application of this Agreement.

Article 5

The competent authorities of the Contracting States will endeavor to assure that the tax benefits provided in this Agreement are not enjoyed by enterprises of third States.

Article 6

The Contracting States shall notify each other through diplomatic channels when the constitutional requirements for the entry into force of this Agreement have been satisfied. The Agreement shall enter into force on the date of the later of these notifications and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Article 7

This Agreement may be terminated by either Contracting State giving notice of termination through diplomatic channels. In such case it shall cease to have effect with respect to taxable years beginning on or after January 1 of the calendar year following the year in which the notice of termination was given.

Done at Caracas this twenty ninth day of December, nineteen hundred eighty seven, in duplicate, in the English and Spanish languages, each text being equally authentic.

For the Government of the United States of America:

Otto Juan Reich
Ambassador of the
United States of
America

For the Government of the Republic of Venezuela:

Simon Alberto Consalvi
Minister for Foreign
Affairs

Part III. Administrative, Procedural, and Miscellaneous

CONTENTS

Delegation Order No. 114 (Rev. 8) 470
Delegation Order No. 137 (Rev. 2) 470
Delegation Order No. 157 (Rev. 5) 470
Delegation Order No. 193 (Rev. 1) 470
Delegation Order No. 209 (Rev. 3) 471
Notice 88–1 471
Notice 88–2 473
Notice 88–3 474
Notice 88–4 474
Notice 88–5 476
Notice 88–6 476
Notice 88–7 476
Notice 88–8 477
Notice 88–9 477
Notice 88–10 478
Notice 88–11 481
Notice 88–12 481
Notice 88–13 481
Notice 88–14 482
Notice 88–15 482
Notice 88–16 482
Notice 88–17 486
Notice 88–18 486
Notice 88–19 486
Notice 88–20 487
Notice 88–21 488
Notice 88–22 489
Notice 88–23 490
Notice 88–24 491
Notice 88–25 495
Notice 88–26 495
Notice 88–27 496
Notice 88–28 496
Notice 88–29 497
Notice 88–30 497
Notice 88–31 511
Notice 88–32 512
Notice 88–33 513
Notice 88–34 516
Notice 88–35 516
Notice 88–36 517
Notice 88–37 522
Notice 88–38 524
Notice 88–39 525
Notice 88–40 526
Notice 88–41 526
Notice 88–42 527
Notice 88–43 528
Notice 88–44 528
Notice 88–45 529
Notice 88–46 530
Notice 88–47 530
Notice 88–48 531
Notice 88–49 532
Notice 88–50 535
Notice 88–51 535
Notice 88–52 537
Notice 88–53 538
Notice 88–54 539
Notice 88–55 539
Notice 88–56 540
Notice 88–57 545
Notice 88–58 546
Notice 88–59 546
Notice 88–60 547
Notice 88–61 547
Notice 88–62 548
Notice 88–63 551
Notice 88–64 552
Notice 88–65 552
Notice 88–66 552
Notice 88–67 555
Notice 88–68 556
Revenue Procedure 88–1 557
Revenue Procedure 88–2 571
Revenue Procedure 88–3 579
Revenue Procedure 88–4 586
Revenue Procedure 88–5 587
Revenue Procedure 88–6 589
Revenue Procedure 88–7 589
Revenue Procedure 88–8 628
Revenue Procedure 88–9 634
Revenue Procedure 88–10 635
Revenue Procedure 88–11 636
Revenue Procedure 88–12 637
Revenue Procedure 88–13 639
Revenue Procedure 88–14 639
Revenue Procedure 88–15 683
Revenue Procedure 88–16 691
Revenue Procedure 88–17 692
Revenue Procedure 88–18 694
Revenue Procedure 88–19 695
Revenue Procedure 88–20 696
Revenue Procedure 88–21 777
Revenue Procedure 88–22 785
Revenue Procedure 88–23 787
Revenue Procedure 88–24 800
Revenue Procedure 88–25 803
Revenue Procedure 88–26 804
Revenue Procedure 88–27 804
Revenue Procedure 88–28 804
Revenue Procedure 88–29 828
Revenue Procedure 88–30 831
Revenue Procedure 88–31 832
Revenue Procedure 88–32 833
Revenue Procedure 88–33 835
Revenue Procedure 88–34 837
Revenue Procedure 88–35 837
Revenue Procedure 88–36 838

Delegation Order No. 114 (Rev. 8)
Effective December 24, 1987

Designation to Act as "Competent Authority" Under Tax Treaties and Exchange of Information Agreements Authorized Under the Caribbean Basin Economic Recovery Act (CBERA)

1. Pursuant to the authority delegated to the Commissioner by Treasury Order No. 150-17, there is hereby delegated to the Assistant Commissioner (International) the authority to act as "competent or taxation authority" under the tax treaties of the United States and under exchange of information agreements authorized under CBERA.

2. The Assistant Commissioner (International) shall have the authority to administer all those functions derived from the operating provisions of the tax treaties and exchange of information agreements authorized under CBERA. This authority may not be redelegated.

3. The Assistant Commissioner (International) is also delegated the authority to interpret and apply such tax treaties and exchange of information agreements authorized under CBERA, but in such matters shall act only with the concurrence of the Associate Chief Counsel (Technical and International). This authority may not be redelegated.

4. Delegation Order No. 114 (Rev. 7), effective October 31, 1987, is hereby superseded.

Delegation Order No. 137 (Rev. 2)
(Effective April 13, 1987)

Authority to Perform Functions Relating to Church Tax Inquiries and Examinations

1. Pursuant to the authority vested in the Commissioner of Internal Revenue under Treasury Delegation Order No. 150-10 and 26 CFR 301.7611-1, District Directors are authorized to hold conferences described in IRC 7611(b)(3)(A)(iii) and to execute agreements under IRC 7611(c)(2)(c) to suspend the periods for completing church tax inquiries or examinations. The authority to perform these functions may be redelegated no lower than Group manager level.

2. To the extent that authority previously exercised consistent with this Order may require ratification, it is hereby affirmed and ratified.

3. This Order supersedes Delegation Order No 137 (Rev. 1) [1976-2 C.B. 624] effective November 10, 1976

Dated: April 13, 1987.

James I. Owens,
Deputy Commissioner.

(Filed by the Office of the Federal Register on April 22, 1987, at 8:45 a.m., and published in the issue of the Federal Register for April 23, 1987, 52 F.R. 13560)

Delegation Order No. 157 (Rev. 5)
(Effective June 15, 1987)

The Seizure and Forfeiture of Personal Property

(1) Pursuant to the authority granted to the Commissioner of Internal Revenue by 26 CFR 403 through 403.65, IRC 7325 and Treasury Department Order No. 150-10,

(a) Special Agents and Internal Security Inspectors are authorized:

1. To seize personal property for forfeiture to the United States when involved, used, or intended to be used, in violation of the internal revenue laws other than Chapters 51, 52 and 53 of the Internal Revenue Code of 1954;

2. To estimate the value of seized personal property, and if valued at $100,000 or less ($2,500 or less for property seized prior to October 22, 1986), to cause a list to be prepared and appraisal to be obtained and to attest such list and appraisement, and to publish notice; and

3. To cause notice of sale to be placed in accordance with 26 CFR 403.55 and to re-advertise the property, when necessary, in accordance with 26 CFR 403.57.

(b) The Assistant Commissioner (International), District Directors and Regional Inspectors are authorized:

1. To make the determinations concerning type and conditions of cost bonds as provided in 26 CFR 403.27;

2. To exercise the authority of the Commissioner concerning disposition of perishable goods provided in 26 CFR 403.30;

3. To execute the declaration of forfeiture showing that personal property has been forfeited to the United States;

4. To acquire for official use seized property by exercising the authority of the Commissioner provided in 26 CFR 403.44;

5. To determine that seized property shall be sold at public auction as provided in 26 CFR 403.55;

6. To order the destruction of any coin-operated gaming device under the provisions of 26 CFR 403.65.

(c) The Assistant Commissioner (Criminal Investigation), and the Director, Internal Security Division, are authorized:

(1) To allow or deny petitions for remission or mitigation of forfeiture, accept or reject any offer in compromise of the liability to forfeiture of personal property, and to make the necessary determinations and notifications, as provided in 26 CFR 403.43, and to authorize the Assistant Commissioner (International), the District Directors or Regional Inspectors to notify the petitioner or offeror of the action taken on the petition or offer.

(2) The authority delegated herein may not be redelegated.

(3) To the extent that the authority previously exercised consistent with this Order may require ratification, it is hereby affirmed and ratified.

(4) Delegation Order No. 157 (Rev. 4) effective May 12, 1986 is superseded.

Dated: June 15, 1987.

James I. Owens,
Deputy Commissioner.

(Filed by the Office of the Federal Register on June 25, 1987, at 8:45 a.m., and published in the issue of the Federal Register for June 26, 1987, 52 F.R. 24086)

Delegation Order No. 193 (Rev. 1)
(Effective August 30, 1987)

Delegation to Deputy Commissioners of Internal Revenue

Pursuant to the authority vested in me as Commissioner of Internal Revenue by Treasury Department Order

best copy available

No. 150-10, the Senior Deputy Commissioner is authorized to perform any function the Commissioner is authorized to perform.

The Deputy Commissioners (Operations) and (Planning and Resources) are authorized to perform only those functions the Commissioner is authorized to perform which arise out of, relate to, or concern the activities or functions each administers.

Each of these officials shall perform functions under this authority in his or her own capacity and under his or her own title and shall be responsible for referring to the Commissioner any matter on which action would appropriately be taken by the Commissioner.

This authority may not be redelegated.

Delegation Order No. 193, effective March 1, 1982, is superseded.

Dated: August 3, 1987.

Lawrence B. Gibbs,
Commissioner.

(Filed by the office of the Federal Register on August 12, 1987, at 8:45 a.m., and published in the issue of the Federal Register for August 13, 1987, 52 F.R. 30278)

Delegation Order No. 209 (Rev. 3) Effective October 28, 1987

Delegation of Authority in Partnership and S Corporation Matters

Pursuant to the authority vested in the Commissioner of Internal Revenue by IRC 6223, 6224, 6231(a)(7), 6232, 6243, and 6244, and Treasury Department Order 150-10:

1. Authority to sign the notice to partners or shareholders at the beginning of an administrative proceeding at the partnership or S corporation level with respect to a partnership or subchapter S item is delegated to Revenue Agents (grade GS-11 and higher).

2. Authority to sign the notice of final partnership or S corporation administrative adjustment is delegated to:

a. Chiefs and Associate Chiefs of Appeals Offices;

b. Appeals Team Chiefs as to their respective cases;

c. Appeals Officers in service centers/Austin Compliance Center;

d. Revenue Agents (Reviewers), (grade GS-11 and higher), in Examination Division or in Office of Compliance, Assistant Commissioner (International); and

(e) Revenue Agents (grade GS-11 and higher) in service centers/Austin Compliance Center.

3. Authority to enter into and approve a written settlement agreement with one or more partners or shareholders with respect to the determination of partnership or subchapter S items for such partnership or S corporation taxable year is delegated to:

a. Chiefs and Associate Chiefs of Appeals Offices;

b. Appeals Team Chiefs as to their respective cases;

c. Appeals Officers in service centers/Austin Compliance Center.

d. Revenue Agents (Reviewers) (grade GS-11 and higher), in Examination Division or Office of Compliance, Assistant Commissioner (International) and

(e) Revenue Agents (grade GS-11 and higher) in service centers/Austin Compliance Center.

4. Authority to designate a Tax Matters Partner with respect to a partnership or a Tax Matters Person for an S corporation is delegated to:

a. Chiefs and Associate Chiefs of Appeals Offices;

b. Appeals Team Chiefs, as to their respective cases; and

c. Group Managers in Examination Division.

5. To the extent that authority previously exercised consistent with this Order may require ratification, it is hereby affirmed and ratified.

The authority delegated herein may not be redelegated.

Delegation Order No. 209 (Rev. 2), effective May 12, 1986, is hereby superseded.

Approved:

Charles H. Brennan,
Deputy Commissioner (Operations).

(Filed by the Office of the Federal Register on October 22, 1987, at 8:45 a.m. and published in the issue of the Federal Register for October 23, 1987, 52 F.R. 39765)

Continuation of Code Section 897(i) Elections by Netherlands Antilles Companies; Anti-Treaty Shopping Rules; Retroactive Section 897(i) Elections

Notice 88-1

This notice provides guidance on the status of elections by Netherlands Antilles companies and certain other treaty country corporations under section 897(i) of the Internal Revenue Code of 1986. Such elections provide that a foreign corporation will be treated as a domestic corporation for purposes of sections 897, 1445, and 6039C of the Code. A section 897(i) election can be made only if the foreign corporation is entitled to nondiscriminatory treatment under any treaty obligation of the United States.

The rules set forth herein provide guidance concerning: (a) the impact of the termination of the income tax treaty between the United States and the Netherlands Antilles on section 897(i) elections made by Netherlands Antilles companies; (b) the application of the anti-treaty shopping provision of the Friendship, Commerce and Navigation treaty between the United States and the Netherlands Antilles and similar treaties; and (c) retroactive elections under section 897(i). This document serves as an "administrative pronouncement" as that term is used in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure. Taxpayers may rely on this notice until section 1.897-3 of the Income Tax Regulations is amended to reflect the guidance contained herein. Any modification of the rules contained herein will be prospective only.

1. Termination of the Protocol to the U.S.—Netherlands Income Tax Convention

The United States is a party to the United States-Netherlands Income Tax Convention, TIAS 1855, T.D. 5778, 1950-1 C.B. 92, as supplemented by the Protocol of June 15, 1955, extending the Convention to the Netherlands Antilles, TIAS 3366, 1956-2 C.B. 1116 and as modified by the 1963 Protocol of October 23, 1963, TIAS 5665, 1965-1 C.B. 624

(the "Antilles Convention"). A notice delivered by the United States to the Kingdom of the Netherlands on June 29, 1987, and modified on July 10, 1987, terminates all provisions of the Antilles Convention other than Article VIII and such other ancillary provisions in the Antilles Convention as apply to effectuate, modify, or limit the exemption from tax provided in Article VIII for interest described therein.

Section 897(i) elections based on the nondiscrimination provision of the Antilles Convention can be made by a Netherlands Antilles company on or before December 31, 1987. Netherlands Antilles corporations which have made such a section 897(i) election on or before December 31, 1987, will be treated as having also made the election under the Friendship, Commerce and Navigation treaty between the United States and the Netherlands Antilles, *infra*, and will be bound by, and receive the benefits of, that election after December 31, 1987, to the extent provided in sections 2 and 3 below. Elections under the Antilles Convention will otherwise terminate as of January 1, 1988.

2. Treaty of Friendship, Commerce and Navigation

The legislative history of section 897 specifically states that the discrimination protection granted by friendship, commerce and navigation treaties may support a section 897(i) election. *See* Conf. Comm. Report No. 176, 97th Cong., 1st Sess. 277-78 (1981). The United States is a party to the Treaty of Friendship, Commerce and Navigation with the Kingdom of the Netherlands, extended to the Netherlands Antilles under Article XXIV thereof (8 UST 2043; TIAS 3942 (1957)) (the "Antilles FCN Treaty"). Article XI of the Antilles FCN Treaty grants nondiscriminatory treatment to companies of either country engaged in trade or other gainful pursuit in the other country. However, Article XXII(1)(e) of the Antilles FCN Treaty (referred to herein as the "anti-treaty shopping provision") provides that the Antilles FCN Treaty does not preclude either country from denying the advantages of the Antilles FCN Treaty to any company controlled, directly or indirectly, by nationals of third countries.

The Internal Revenue Service hereby announces that companies formed under the laws of the Netherlands Antilles which are controlled, directly or indirectly, by nationals of third countries may not rely on the nondiscrimination provisions of the Antilles FCN Treaty as the basis for making a section 897(i) election after May 2, 1988. Such companies will be considered controlled by nationals of a third country if 50% or more of the voting power of any class of stock entitled to vote, or 50% or more of the value of any class of stock, is held directly or indirectly by nationals of third countries. The attribution rules of section 883(c)(4) of the Code will apply to determine control. A corporation meeting the requirements of section 884(e)(4)(B) (relating to certain publicly traded corporations) will not be treated as controlled by nationals of third countries. In addition, companies entitled to the benefits of the nondiscrimination provisions contained in any other friendship, commerce and navigation treaty (an "FCN treaty") which contains an anti-treaty shopping provision similar to Article XXII(1)(e) of the Antilles FCN Treaty may not rely on such nondiscrimination provision if the company is controlled, directly or indirectly, by nationals of third countries.

A company which makes a section 897(i) election on or before May 2, 1988, in reliance on an FCN treaty's nondiscrimination provision, but which does not conform to the anti-treaty shopping provision of the FCN treaty, will be bound by, and receive the benefits of, that election only as provided in section 3 below. A company will be considered not to conform to the anti-treaty shopping provisions of an FCN treaty if it does not satisfy the anti-treaty shopping provision of an FCN treaty at either the time the election is made or the time of an acquisition or disposition of a U.S. real property interest. Any such company will be referred to herein as having made an "FCN treaty-shopping election."

A section 897(i) election based on the Antilles Convention, pursuant to section 1.897-3(c)(1)(ii), will be treated as having been made under the Antilles FCN Treaty for purposes of transactions occurring on or after January 1, 1988, and for purposes of section 3 of this Notice. Accordingly, a Netherlands Antilles company's section 897(i) election which would otherwise terminate on January 1, 1988, will continue to be in effect to the extent that the election would continue to be in effect after January 1, 1988 if the election had originally been made under the Antilles FCN Treaty. Thus, a section 897(i) election that is not an Antilles FCN treaty-shopping election will remain fully in force without regard to the provisions of section 3, below. A section 897(i) election which is an FCN treaty-shopping election will be subject to the rules set forth in section 3, below.

3. FCN Treaty-Shopping Section 897(i) Elections

The provisions of this section 3 apply to any company which on or before May 2, 1988, makes an FCN treaty-shopping election. This section 3 does not apply to a valid section 897(i) election made under any income tax convention in effect after December 31, 1987. A section 897(i) election can only be made under the nondiscrimination provisions of most income tax treaties to which the United States is a party if the company has a permanent establishment in the United States. *See, e.g.*, Article 24(3) of the U.S. Treasury Department's Model Income Tax Treaty dated June 16, 1981.

A. Effect of Elections Made on or before May 2, 1988 for the Period January 1, 1988 to May 2, 1988

For the period January 1, 1988, through May 2, 1988, an FCN treaty-shopping election made on or before May 2, 1988, is effective with respect to transactions occurring during that period, except that in no event shall such election apply to property acquired or disposed of by the electing corporation for which it has a section 1223 holding period commencing on or after January 1, 1988.

B. Effect of Elections Made on or before May 2, 1988 for the Period Beginning after May 2, 1988

After May 2, 1988, the stock of a company which has made an FCN treaty-shopping election will be treated as a United States real property interest if (a) the company acquired or disposed of a U.S. real property interest prior to May 3, 1988, and (b) the section 897(i) election affects the tax consequences to the transferor or transferee in the acquisition or disposition of such U.S. real property interest, not including withholding tax consequences under section 1445. If a transaction described in the preceding sentence does not occur on or before May 2, 1988, then the election will be treated as terminating on May 3, 1988.

If the stock of the electing company is treated as a U.S. real property interest after May 2, 1988 pursuant to the provisions of the preceding paragraph, then the election will continue to apply to dispositions of stock in that company by a shareholder after May 2, 1988, until the company has disposed of all U.S. real property interests (or property described in section 1.897-3(c)(3)(ii) for which the company has a section 1223 holding period commencing before January 1, 1988. As long as the company's section 897(i) election is in effect pursuant to this section 3, the election will continue to apply to the disposition by the electing company of all U.S. real property interests (or property described in section 1.897-3(c)(3)(ii)) for which it has a section 1223 holding period commencing before January 1, 1988. The section 897(i) election will in no event apply after May 2, 1988, to any disposition by the electing company of a U.S. real property interest for which the electing company has a section 1223 holding period commencing on or after January 1, 1988, or to any acquisition by the company of a U.S. real property interest in a transaction described in the nonrecognition provisions of the Code. For example, if after May 2, 1988, a foreign shareholder transfers a U.S. real property interest to an electing corporation in a transaction described in section 351, the stock in the electing corporation will not be treated as a U.S. real property interest in the hands of the foreign shareholder for purposes of applying section 897(e) to the exchange.

4. Retroactive Elections under Section 897(i)

Except as provided below, a foreign corporation entitled to nondiscrimination protection can make a retroactive section 897(i) election, as provided in section 1.897-3(d)(2). Normally, a section 897(i) election is made prior to the disposition of a U.S. real property interest by a foreign corporation, including dispositions pursuant to the liquidation of the foreign corporation. Questions have been raised as to whether the election had to be made by a foreign corporation prior to a disposition of a U.S. real property interest which would be taxable but for the election (*e.g.*, transfers in certain reorganizations).

A retroactive section 897(i) election can be made after such a real property interest disposition by a foreign corporation entitled to nondiscrimination treatment provided the conditions of section 1.897-3(d)(2) are satisfied, *i.e.*, (a) payment has been made in an amount equal to the sum of all federal income taxes (plus interest thereon) which would have been due on dispositions of interests in the foreign corporation (or a disposition described in section 1.897-3(e)) during the period set forth in section 1.897-3(c)(5) if the section 897(i) election were in effect during that period, or (b) all such dispositions took place under circumstances in which the transferee's basis was the same as the transferor's basis, increased by any gain recognized by the transferor and any tax paid by the transferor under chapter 1 of the Code. In addition, if there has been a prior disposition of a United States real property interest by such corporation, payment must be made of a sum equal to all federal income taxes (including interest and penalties), if any, which would be due upon such a disposition by a domestic corporation. Such a retroactive election can establish the tax free status of a liquidation or reorganization under section 897(d)(2) or section 897(e). In the case of a corporation no longer in existence, a retroactive election can be made by any successor-in-interest to such corporation which is liable for the payment of the corporation's federal income tax liability, or by any person who was an officer of such corporation who was liable for the payment of any tax liability of such corporation under sections 6672(a) and 6671(b).

Retroactive section 897(i) elections based on the Antilles Convention may not be made after December 31, 1987. Retroactive FCN treaty-shopping elections may not be made after May 2, 1988. A section 897(i) election may be revoked prospectively, in accordance with the procedures of section 1.897-3(f).

Transitional Rule for Registered Gasohol Blenders to Purchase Gasoline and Pay the Reduced Tax Rate

Notice 88-2

The purpose of this notice is to notify taxpayers and other affected persons that for the first quarter of 1988, the Internal Revenue Service ("Service") will provide a transitional rule that under certain conditions will allow all registered gasohol blenders to purchase gasoline and pay the reduced rate of tax on the gasohol mixture under section 4081(c) of the Internal Revenue Code of 1986 ("Code"). The transition period will allow the Service to consider and address the concerns of the industry and others as to the manner in which the refund procedure provided by the Tax Reform Act of 1986 in section 6427(i)(3) of the Code, when fully implemented, should apply when gasoline used in producing gasohol is purchased at 9.1 cents a gallon.

For now, in lieu of using the refund procedure provided in sections 6427(f) and (i)(3) of the Code and §48.6427-3(f) of the proposed regulations that were published in the Federal Register on November 18, 1987 (52 FR 44141), any registered blender of gasohol is allowed to purchase gasoline at the reduced rate of tax (3 1/3 cents a gallon plus the Leaking Underground Storage Tank Trust Fund financing rate), provided the registered gasohol blender files a Quarterly Federal Excise Tax Return (Form 720) for the first quarter of 1988, in accordance with the instructions for that Form. Those instructions will provide that such return must report the total volume of gasoline purchased at the reduced rate and the total volume of gasohol produced by the blender for the first quarter of 1988, in addition to any excise tax liability.

Under section 4081(c)(2) of the Code, gasohol blenders that purchase gasoline at the reduced rate of tax will be liable for an excise tax liability of 5 2/3 cents for each gallon, in addition to the 3 1/3 cents tax already imposed on each gallon of gasoline under section 4081(c)(1) of the Code, if they (1) fail to blend such gasoline with alcohol to produce gasohol, or (2) having blended the gasoline to produce gasohol, separate such gasoline.

In addition, all gasohol blenders purchasing gasoline at the reduced rate during the first quarter of 1988, must maintain records as provided in regulation §48.4081-2(h)(3) (relating to records of producer of gasohol).

The Service announced on December 9, 1987 (I.R.S. Notice 87-83), that when the proposed regulations on the gasoline excise tax are issued in temporary or final form, they will provide that Certificates of Registry issued under section 4101 of the Code as in effect prior to January 1, 1988, will be revoked on March 31, 1988, rather than on December 31, 1987. In addition, the bond requirements in the regulations will be effective April 1, 1988, instead of January 1, 1988. Therefore, until April 1, 1988, taxpayers may rely on registrations currently in effect for all purposes for which registration is relevant under the proposed regulations, including determination of whether a gasohol blender is registered for purposes of proposed regulation §48.4081-1(a)(3). A gasohol blender that wishes to qualify for the reduced rate of tax on purchases of gasoline to be used in the production of gasohol, but that does not currently hold a Certificate of Registry, will be required to register. Application for registration by a gasohol blender should be made on new Form 637 (Rev. October 1987), if that form is available at the appropriate IRS district office. If that form is unavailable, application for registration should be made as a producer of gasohol on Form 637 as in use under section 4101 of the Code as in effect prior to January 1, 1988 ("old Form 637"). In either case, the applicant must mark "Priority—new gasoline excise tax registrant" on the top of the Form 637 and on any envelope used for mailing the Form. Due to the time constraints in processing new Certificates of Registry, new registrants are encouraged to submit a Form 637 to the appropriate district director as soon as possible. No bond (Form 928) is required for these registrations (until the new registration and bond requirements take effect). Any registration on the old Form 637 will be revoked as of the close of business on March 31, 1988. Any registrant using the new Form 637 to register as a gasohol blender may be required to provide the Service with additional information to maintain a valid registration effective April 1, 1988, if different procedures are provided by the Service for purchasing gasoline at the reduced tax rate.

Exclusion Limit for Employer-Provided Dependent Care Assistance Payments

Notice 88-3

Section 1163(a) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 427, amended section 129(a) of the Internal Revenue Code by imposing a specific dollar limit on the exclusion of dependent care expenses. This amendment applies to tax years beginning after December 31, 1986.

Section 129(a)(2) of the Code provides, in general, that a taxpayer may exclude from gross income a maximum of $5,000 of employer-provided dependent care assistance in any taxable year. The maximum exclusion for a married individual filing a separate return is $2,500.

Cafeteria plans established by employers under section 125 of the Code often offer dependent care assistance coverage as a benefit to employees. For this assistance to be a qualified benefit, dependent care expenses must be incurred in the plan year for which coverage thereof is elected. Q&A18 of section 1.125-1 of the Proposed Income Tax Regulations provides that dependent care expenses are treated as incurred when the dependent care is provided and not when the employee is billed or charged, or pays for the dependent care.

Example:

Under a cafeteria plan an employee is provided dependent care assistance. In 1985, the employee irrevocably elects to be reimbursed $9,600 for dependent care assistance in 1986. In 1986, the employee incurs expenses in the amount elected but is reimbursed $8,800. As a result of the time necessary to process reimbrusements, the employee receives the $800 balance in 1987. The employee may exclude the entire $9,600 in 1986, regardless of the fact that $800 was reimbursed in 1987, because (1) all the dependent care expenses are treated as incurred in 1986 when the services were provided and (2) there is no limitation on the amount of exclusion for 1986 (other than the earned income limitation set forth in section 129(b) of the Code). Also, the $800 balance received by the employee in 1987 is not counted against the employee's new limit ($5,000 or $2,500) available for 1987.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Calculation of the Excise Tax on Regulated Investment Companies

Notice 88-4

This notice addresses two issues relating to the application in 1987 of section 4982 of the Internal Revenue Code. As amended by the Tax Reform Act of 1986 (the "Act"), section 4982 of the Code imposes a nondeductible excise tax on any regulated investment company ("RIC"). The excise tax is effective for calendar years beginning after December 31, 1986. The excise tax is equal to 4 percent of the excess, if any, of the RIC's "required distribution" for any calendar year over the RIC's "distributed amount" (as defined in section 4982(c)) for such calendar year.

The required distribution of a RIC for a calendar year is defined in section 4982(b)(1) to mean 97 percent of the RIC's ordinary income for such calendar year plus 90 percent of the RIC's capital gain net income for the one-year period ending on October 31 of such calendar year. (Under legislation pending at the time of the release of this notice, the distribution percentage of capital gain net income is increased to 98 percent.) Under section 4982(b)(2), the required distribution for a calendar year is increased by the excess of the "grossed up required distribution" (as defined in section 4982(b)(3)) for the preceding calendar year over the distributed amount for the preceding calendar year.

Effective Dates Applicable for Purposes of Section 4982

For purposes of calculating the excise tax under section 4982, a RIC is required to calculate its capital gain net income by treating the one-year period ending on October 31 as its taxable year and is required to calculate its ordinary income by treating the calendar year as its taxable year. Questions have been raised regarding the effective date, for purposes of section 4982, of those provisions of the 1986 Act that are effective with reference to the taxable year of the taxpayer. Specifically, the issue is whether the applicability of these provisions, for purposes of section 4982, is to be based upon the taxable year the RIC is treated as having under section 4982 or upon the actual taxable year of the RIC.

When issued, regulations under section 4982 will provide that the treatment of a RIC as having a calendar year or a year ending October 31 as its taxable year for purposes of section 4982 will not apply for the purpose of determining the applicability of provisions the effective date of which is determined with reference to the taxable year of the taxpayer. Rather, the actual taxable year of the RIC will be used to determine the applicability of such provisions.

Example. RIC M has a taxable year ending June 30. During 1987, M enters into numerous "section 988 transactions," as defined in section 988(c)(1) of the Code (determined without regard to the effective date of section 988). Section 988 generally applies to taxable years beginning after December 31, 1986. The effective date of section 988, for purposes of determining M's excise tax liability under section 4982, is determined based upon M's actual taxable year. Accordingly, for purposes of section 4982, section 988 will apply to transactions closed after June 30, 1987, and will not apply to transactions closed before July 1, 1987.

Calculation of the Grossed Up Required Distribution for 1986

Although section 4982 is effective for calendar years beginning after December 31, 1986, the required distribution of a RIC for calendar year 1987 is, under section 4982, increased by the excess, if any, of (a) the "grossed up required distribution" for calendar year 1986 over (b) the distributed amount for calendar year 1986. The grossed up required distribution of a RIC for calendar year 1986 is an amount equal to the sum of (a) 100 percent of the RIC's ordinary income for calendar year 1986, (b) 100 percent of the RIC's capital gain net income for the period beginning November 1, 1985 and ending October 31, 1986, and (c) any prior year shortfall. Generally, such prior year shortfall may be derived from amounts reported in prior taxable years.

Under these rules, for purposes of determining the required distribution for calendar year 1987, RICs with taxable years not ending on October 31, 1986 are required to determine separately the amount of their capital gain net income for the portion of their taxable year ending before November 1, 1986 and for the portion beginning after October 31, 1986. The Internal Revenue Service has concluded that, in light of the fact that no excise tax was imposed in calendar year 1986, it is inappropriate to subject RICs to the increased accounting costs and, in certain cases, increased distribution requirements that would result from a separate determination of pre-November 1, 1986 and post-October 31, 1986 capital gain net income. Accordingly, when issued, regulations under section 4982 will provide that, in lieu of separately calculating capital gain net income for the pre-November 1 and post-October 31 portions of a taxable year that includes October 31, 1986, a RIC may (but is not required to) treat all of its capital gains and losses for the taxable year as attributable to the pre-November 1 portion of the taxable year for purposes of calculating its grossed up required distribution for calendar year 1986.

Example 1. RIC N is a calendar taxpayer. During calendar year 1986, N has capital gain net income of $100. In order to avoid the cost of closing its books as of October 31, 1986 to determine its pre-November 1, 1986 and post-October 31, 1986 capital gain net income, N may treat all of the capital gain net income as attributable to the pre-November 1, 1986 portion of its taxable year. In calculating N's required distribution for calendar year 1987, under section 4982(b)(2)(A), the $100 will be included in N's grossed up required distribution for 1986. The $100 will not be included in N's capital gain net income for the one-year period ending on October 31, 1987, under section 4982(b)(1)(B).

Example 2. RIC O has a taxable year ending March 31. During its taxable year ending March 31, 1987, O has capital gain net income of $60, consisting of capital gain income of $100 for the pre-November 1 portion of the taxable year and a capital loss of $40 for the post-October 31 portion of the taxable year. O may treat its pre-November 1 capital gain net income as equal to $60. In calculating O's required distribution for calendar year 1987, under section 4982(b)(2)(A), O may include the $60 in its grossed up required distribution for 1986. In that case, the $40 loss will not be included in O's capital gain net income for the one-year period ending on October 31, 1987, under section 4982(b)(1)(B).

A RIC is not required to file an election with the Internal Revenue Service indicating the manner in which it calculates its grossed up required distribution for calendar year 1986. If, however, in determining its liability for the tax imposed by section 4982 for any period, a RIC takes an item of gain or loss attributable to the post-October 31, 1986 portion of a taxable year into account in a manner inconsistent with the optional method allowed by this notice, the treatment provided for such item in this notice is not allowed.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Treaty-Based Equivalent Exemptions for Shipping and Aircraft Income

Notice 88-5

The Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 1, modified sections 872(b) and 883 of the Internal Revenue Code. Those sections now provide that a nonresident alien individual or foreign corporation may generally exclude from gross income amounts derived from the operation of ships and aircraft if the individual's country of residence or the corporation's country of incorporation grants an equivalent exemption to United States taxpayers. Section 883(c) generally denies the exclusion to a foreign corporation if 50 percent or more of the value of its stock is owned by individuals who are not residents of its country of incorporation, or of another country that grants an equivalent exemption.

The equivalent exemption may be based on the foreign country's domestic law or on income tax treaties. Most income tax treaties to which the United States is a party provide for reciprocal shipping and aircraft income exemptions. Under some of these treaties, the exemption is available only if the taxpayer's ships or aircraft are registered in its country of residence or incorporation. This notice informs taxpayers that if a foreign corporation deriving income from the operation of ships or aircraft and claiming benefits under section 883(a) of the Code is owned by residents of a third country that has a tax treaty with the United States, section 883(c) will not apply only if the foreign shareholders meet the requirements (including registry limitations) of the reciprocal exemption article of the treaty.

For example, Country *X*'s domestic law provides United States corporations a full exemption from tax on shipping income, but Country *Y*'s does not. A tax treaty between the United States and Country *Y* exempts shipping income of residents of the other country only if the ships are registered in the taxpayer's country of residence. If a shipping corporation organized in Country *X* is owned by residents of Country *Y*, therefore, section 883(c) of the Code will not bar an exclusion under section 883(a) for income earned by ships registered in Country *Y*, but will bar an exclusion for income earned by ships registered elsewhere.

In December of 1986, the United States sent notice of the changes in sections 872(b) and 883(a) of the Code to foreign governments whose tax treaties contain the registry or "flag" limitation on shipping and aircraft income exemptions, and expressed an interest in modifying those provisions to conform to the new statutory rules. These modifications could provide reciprocal exemptions retroactive to January 1, 1987. Otherwise, the exclusion that section 883(a) of the Code provides for shipping and aircraft income earned on or after that date will be limited as described in this notice.

This document serves as an "administrative pronouncement" as that term is used in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied on to the same extent as a revenue ruling or revenue procedure. *See* Rev. Rul. 87-138, 1987-2 C.B. 287.

Amendment of Plans to Comply with Proposed Regulations Sections 1.401(a)-4 and 1.411(d)-4 on Alternative Benefits—Effective Dates

Notice 88-6

The effective dates for existing plans provided in Proposed Regulation sections 1.401(a)-4 and 1.411(d)-4 (51 FR 3798, January 30, 1986) will be extended in the forthcoming Treasury decision with respect to these regulations. In no event will the effective dates for existing plans, as defined in such regulations, be earlier than ninety days after the earlier of (i) the publication of a subsequent notice setting forth revised effective date rules, or (ii) the publication of the Treasury decision with respect to such regulations.

Taxpayers may rely on this notice for guidance pending the issuance of a subsequent notice or final regulations. Thus, taxpayers with existing plans as defined in the proposed regulations, who otherwise qualify for the amendment alternatives provided for in the transitional rules of such regulations but for the effective dates applicable to such rules, may continue to make the amendments provided for in the transitional rules until the later of the effective date for such plan as provided in the proposed regulations or the extended effective date described above.

This notice does not extend the effective date for making retroactive amendments required by Notice 87-46, 1987-1 C.B. 502, with respect to certain impermissible amendments. Furthermore, this notice does not extend the effective date with respect to those alternative benefit provisions and provisions for consent, discretion or other conditions on availability which are subject to the effective date rules applicable to new plans pursuant to the terms of Proposed Regulation sections 1.401 (f)-4 A-6(c) and 1.411(d)-4 A-8(c).

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Application of Section 382(l)(5)(D) to Certain Transactions in which the Federal Savings and Loan Insurance Corporation establishes a Federal Mutual Domestic Building and Loan Association

Notice 88-7

The Internal Revenue Service intends to promulgate regulations clarifying the effect of section 382 (l)(5)(D) on certain transactions in which the Federal Savings and Loan Insurance Corporation ("FSLIC") places defaulted thrift institutions into receivership as part of its Management Consignment Program ("MCP"). The program is operated by FSLIC pursuant to its authority under section 1729(a) and (b) of title 12, United States Code.

Under the current MCP, a stock or mutual savings and loan association ("S&L") that is in default is placed in receivership, an interim mutual S&L (the "interim association") is established, and the assets and liabilities of the defaulted institution are transferred to the interim association, which continues the business of the transferor corporation. The interim association remains in existence only until FSLIC is able to transfer the assets and liabilities of the association to a qualified purchaser. This manner of liquidating a defaulted S&L is generally referred to as a "passthrough receivership".

Section 382(l)(5)(A) provides that the section 382 limitation on the utilization of net operating losses will not apply in the case of an ownership change with respect to certain financially distressed corporations. In general, such relief is available if (i) the loss corporation is under the jurisdiction of the court in a title 11 proceeding or a similar case and (ii) the shareholders and qualified creditors of the loss corporation, immediately before an ownership change, own at least 50 percent of the loss corporation stock immediately after the ownership change. A more liberal exception to the application of the section 382 limitation is available for certain financial institutions that undergo a reorganization described in section 368(a)(3)(D)(ii). Section 382(l)(5)(D) provides, however, that such relief with respect to an ownership change is made inapplicable if there is a subsequent ownership change within a two year period.

The regulations to be promulgated will address the treatment of a pass through receivership in which, immediately before the defaulted association is placed into receivership, the depositors of a stock S&L (or the members of a mutual S&L) own, in substance, the entire equity interest in the association and continue to own the entire equity interest in the interim association until its liquidation. The regulations will provide that the transfer of the defaulted loss corporation's assets and liabilities to the interim association, pursuant to section 1729(a) and (b) of title 12, United States Code, will not constitute an event described in section 1.382-2T(a)(2)(i). Accordingly, the transfer will not result in an ownership change.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Guidance on Application of Section 457 to Nonelective, Vacation, Sick Leave and Other Plans

Notice 88-8

Section 457 of the Internal Revenue Code, as amended by the Tax Reform Act of 1986, provides that amounts of compensation deferred under certain "eligible deferred compensation plans" maintained by state and local governments and tax-exempt organizations are only included in a participant's, or beneficiary's, gross income in the taxable year in which the compensation is paid or otherwise made available to that individual. In general, where the plan is not an "eligible deferred compensation plan", the amounts deferred are included in the individual's gross income in the first taxable year of the individual for which there is no substantial risk of forfeiture. Question and answer 26 in Notice 87-13 published in 1987-1 C.B. 432 clarifies that section 457 applies to all deferred compensation plans of such employers, which may include nonelective deferred compensation plans as well as certain vacation leave, sick leave, compensatory time, severance pay, disability pay, and death benefit plans.

The Service understands that prior to the publication of Notice 87-13 certain state and local governments and tax-exempt organizations believed that section 457 was not applicable to any nonelective deferred compensation, vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plans. The Service is attempting to develop rules clarifying the extent to which section 457 applies to such plans.

In the meantime, the Service has determined that a nonelective deferred compensation plan maintained by a state or local government, or tax-exempt organization, will not be subject to the provisions of section 457 for taxable years of employees beginning before January 1, 1988.

In addition, the Service has determined that a bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan maintained by a state or local government or a tax-exempt organization will not be subject to the provisions of section 457 for taxable years of employees beginning before the issuance of guidance describing the extent to which these forms of compensation are subject to section 457. The exemption applies to such plans whether they are elective or nonelective.

No inference should be drawn from this notice as to the future treatment of such plans under section 457. The Service is currently studying a number of issues raised under section 457. Further guidance will be provided on these issues.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Plan Amendments Required under Rev. Rul. 86-74 May Be Deferred

Notice 88-9

The guidelines for integrating pension, annuity, profit-sharing and stock bonus plans with benefits provided by the Social Security Act were modified by Rev. Rul. 86-74, 1986-1 C.B. 205, to reflect changes made by the Social Security Amendments of 1983, Pub. L. 98-21, 1983-2 C.B. 309. See also Rev. Rul. 71-446, 1971-2 C.B. 187. The Social Security Amendments of 1983 (1) amended the Code to include certain items of deferred compensation in the definition of taxable wages and (2) changed the age at which unreduced old-age insurance benefits commence under the Social Security Act for those born after January 1, 1938.

If a plan in existence on May 27, 1986, was in compliance with the qualification requirements for integrated plans prior to the modifications provided in Rev. Rul. 86-74, then it was required to adopt any plan amendments necessary to comply with such modifications by the last day of the first plan year beginning after December 31, 1986. The amendments were required to be effective as of the first day of such plan year with respect to any plan participant having any service after December 31, 1986. For plans other than those described above, the modifications in the revenue ruling were effective as of the first day of the first plan year beginning after May 27, 1986.

This notice provides that, subject to certain conditions, the adoption date for plan amendments required under Rev. Rul. 86-74 may be deferred until the earlier of (1) the date by which the plan is required to be amended to comply with the provisions of the Tax Reform Act of 1986 (TRA '86), 1986-3 C.B. Volume 1, as determined under section 1140 of such Act (in general, the last day of the first plan year beginning on or after January 1, 1989), or (2) the date the plan is amended to comply with TRA '86.

Notice 87-57, 1987-2 C.B. 368, states that certain amendments to comply with TRA '86 must be made at the time of a plan's termination in order for the plan to retain qualified status. Accordingly, plans that terminate after the effective date specified for the plan in section 6 of Rev. Rul. 86-74 but prior to the date amendments are required under section 1140 of TRA '86 must satisfy the requirements stated below and must adopt the amendments required under Rev. Rul. 86-74 on or before the date of plan termination.

The deferred amendment date is available only to plans that (1) were in existence on May 27, 1986, (2) do not satisfy the integration requirements as modified by Rev. Rul. 86-74, and (3) received a favorable determination letter for TEFRA, DEFRA and REA. Until further notice any determination letter issued with respect to such an ongoing plan prior to the date amendments are required under section 1140 of TRA '86 will not consider whether or not the plan satisfies the requirements of Rev. Rul. 86-74. However, if specifically requested by the taxpayer to do so, the Service will consider such requirements as part of the determination process. Such a request should be clearly stated across the top of the first page of the appropriate form in the 5300 series (or Form 6406 if appropriate). In this case, the determination letter which is issued will state that the requirements of Rev. Rul. 86-74 were considered in determining the qualified status of the plan.

The availability of the deferred amendment date is also conditioned on satisfaction of the following requirements: (1) The plan must be operated in compliance with the requirements for integrated plans specified in Rev. Rul. 71-446, as modified by Rev. Rul. 86-74, beginning on the effective date specified for the plan in section 6 of Rev. Rul. 86-74 as described above; (2) the plan must be amended in a manner which is consistent with its method of operation under (1) by the deferred amendment date described above and such amendment must be made retroactively effective to the effective date applicable to the plan under Rev. Rul. 86-74; and (3) in accordance with Code section 411(d)(6) neither the amendments under (2) nor the plan's method of operational compliance under (1) may reduce any plan participant's accrued benefit as of the later of the effective date specified for the plan in Rev. Rul. 86-74 or the date on which operational compliance began in accordance with this notice.

Election of Taxable Years by Certain Partnerships, S Corporations and Personal Service Corporations

Notice 88-10

The Internal Revenue Service has received many inquiries regarding section 10206 of the Omnibus Budget Reconciliation Act of 1987. That section allows certain partnerships, S corporations, and personal service corporations to elect the use of a particular taxable year for Federal income tax purposes. The purpose of this notice is to provide guidance with respect to certain issues that are of immediate concern to taxpayers.

I. Background

Sections 441(i), 706(b), and 1378 of the Internal Revenue Code (the "Code"), as amended by section 806 of the Tax Reform Act of 1986 (Pub. L. 99-514) [1986-3 (Vol. 1) C.B. 279] (the "1986 Act") generally requires personal service corporations, partnerships, and S corporations, respectively, to conform their taxable years to the taxable years of their owners. These sections are effective for taxable years beginning after December 31, 1986.

New section 444 of the Code, as added by section 10206 of the Omnibus Budget Reconciliation Act of 1987 (Pub. L. 100-203) (the "1987 Act") enacted into law on December 22, 1987, allows certain partnerships, S corporations and personal service corporations to elect the use of a taxable year that is different from the taxable year that such entities would otherwise be required to use under section 806 of the 1986 Act (the "required taxable year"). Section 444 is effective for taxable years beginning after December 31, 1986.

Under the 1987 Act, partnerships and S corporations may elect the use of a taxable year that is different from their required taxable year if those partnerships and S corporations follow the procedures established under sections 444 and 7519 of the Code. Under those procedures, electing partnerships and S corporations are required to make payments ("required payments") to the Federal government that are intended to represent the value of the tax deferral obtained by the owners of those entites through the use of a taxable year different from the required taxable year.

Similarly, under the 1987 Act, personal service corporations may elect the use of a taxable year that is different from their required taxable year if those corporations follow the procedures established under sections 444 and 280H of the Code. Under those procedures, electing personal service corporations failing to distribute certain amounts to employee-owners by December 31 of any taxable year may be required to defer certain deductions for amounts paid to employee-owners.

II. Application of Elective Procedures in General

The Service has received many questions concerning the effect of section 10206 of the 1987 Act on taxable years for which the taxpayer has established a business purpose to the satisfaction of the Secretary of the Treasury.

Forthcoming temporary regulations will provide that partnerships, S corporations and personal service corporations which have a taxable year for which such entity establishes a business purpose to the satisfaction of the Secretary of the Treasury, as provided under law, are not required to use a section 444 election and are not required to make payments under section 7519(b) of the Code in order to use such taxable year. Thus, for example, a partnership which has a taxable year for which it has established a business purpose to the satisfaction of the Secretary, as provided under section 706(b)(1)(C) of the Code, may use such year.

III. Due Dates For Election to Use Taxable Year and Required Payment

Section 10206(d)(3) of the 1987 Act provides that any election made under section 444 of the Code (a "section 444 election") shall not be required to be made before the 90th day after the enactment of the 1987 Act (i.e., March 21, 1988). Furthermore, section 7519(f)(2) of the Code requires that any required payment made by a partnership or S corporation making a section 444 election for its first taxable year beginning in 1987 shall be made on or before April 15, 1988 (or such later date as may be prescribed by the Secretary).

Under forthcoming temporary regulations, a section 444 election shall not be required to be made before the later of (i) April 30, 1988, or (ii) 60 days after publication of those temporary regulations in the Federal Register. Guidance will be provided in the temporary regulations regarding the procedures for making a section 444 election, including the filing of a new election form which is expected to be available by March 1988. Prior to the publication of those regulations, taxpayers should not attempt to make section 444 elections.

In addition, the forthcoming temporary regulations will (i) describe the procedures for making payments, including the filing of any supporting calculations and tax return, and (ii) provide general guidance with respect to section 10206 of the 1987 Act. Under those regulations, required payments for the first election year will be due no earlier than the due date of the section 444 election.

IV. Period During Which a Taxable Year May Be Retained Under Section 444(b)(3)

Section 444(b)(3) of the Code provides that "[i]n the case of an entity's first taxable year beginning after December 31, 1986, an entity may elect a taxable year under subsection (a) which is the same as the entity's last taxable year beginning in 1986." Several taxpayers have interpreted this language, in conjunction with section 444(a), as only allowing an entity to retain its taxable year for its first taxable year beginning after December 31, 1986, but then requiring the entity to change to a taxable year with a deferral period of no more than three months for the entity's taxable year beginning after December 31, 1987.

Forthcoming temporary regulations will provide that an entity electing a taxable year under section 444(b)(3) of the Code may continue the use of that taxable year (if otherwise allowed under section 444 and any other provision of law) for all subsequent taxable years.

V. Definition of Employee-Owner and Personal Service Corporation

Section 280H(f)(2) of the Code defines the term "employee-owner" as the meaning given to such term by "section 269A(b)(2)" (sic). Pending the enactment of clarifying legislation, the Service will treat the term "employee-owner" in section 280H(f)(2) as having the meaning given such term in section 269a(b)(2), as modified by section 441(i)(2) of the Code.

Moreover, the forthcoming temporary regulations will define the term "personal service corporation" in sections 444 and 280H of the Code to be a personal service corporation as defined in section 441(i)(2) and the regulations thereunder.

VI. Corporations Electing S Status

A. Corporations Electing S Status for a Taxable Year Beginning in 1987

The Service has received many questions concerning corporations that elected S status after September 18, 1986 and before January 1, 1988 for their taxable year beginning in 1987. Specifically, taxpayers are uncertain whether such corporations may elect, pursuant to section 444(b)(3) of the Code, a taxable year which is the same as the corporation's last taxable year beginning in 1986. The uncertainty results because the Conference Report to the 1987 Act can be read to conclude that such corporations are limited to a taxable year that results in no more than a three-month deferral period.

Based upon the express language of section 444(b)(3) of the Code, forthcoming temporary regulations will provide that section 444(b)(3) applies to a corporation electing S status for its taxable year beginning in 1987. Thus, for example, assume that a C corporation with a taxable year ending June 30, 1987, properly elects to be an S corporation for its taxable year beginning July 1, 1987. Under section 444(b)(3), that corporation may elect to retain its taxable year ending June 30 for its taxable year beginning in 1987, assuming that such election is otherwise allowed under section 444 and any other provision of law. This conclusion will result notwithstanding the fact that such corporation may have agreed to change its taxable year to a calendar year as a condition of making its S election with the Service.

The forthcoming temporary regulations will also provide that a corporation which elects S status for a taxable year beginning in 1987, but does not elect to retain its existing taxable year under section 444(b)(3) of the Code may use the provisions of section 444(b)(2) to change its taxable year.

B. Corporations Electing S Status for a Taxable Year Beginning in 1986 and Ending December 31, 1986

Forthcoming temporary regulations will provide that the provisions of section 444(b)(3) of the Code do not apply to corporations that elected S status for taxable years beginning in 1986 and ending December 31, 1986. This conclusion results because section 444(b)(3) only applies to taxable years beginning in 1987.

Forthcoming temporary regulations will also provide that corporations that elected S status for a taxable year beginning in 1986 and ending on December 31, 1986, however, are allowed to change their taxable year under section 444(b)(2) of the Code by treating the deferral period of the taxable year being changed as the same as the deferral period of the last taxable year of the corporation when it was a C corporation. See section 10206(d)(4) of the 1987 Act.

For example, assume a C corporation with a taxable year ending July 31 elects on October 1, 1986 to be an S corporation for its taxable year beginning August 1, 1986 and ending December 31, 1986. Further assume the corporation is otherwise qualified to make a section 444 election for its taxable year beginning in 1987 and desires to use a September 30 taxable year for such year. Given these facts, the S corporation will have a short period income tax return for the period January 1 to September 30, 1987 (see section XI of this notice for an extension of the due date of such return).

In addition, pursuant to section 10206(d)(4) of the 1987 Act, forthcoming temporary regulations will provide that such S corporation may, at its option, retain its calendar year for 1987 and then change to a September 30 taxable year for its taxable year beginning January 1, 1988.

VII. Tiered Structures

Section 444(d)(3) of the Code provides that any entity which is part of a tiered structure cannot make a section 444 election, unless the tiered structure is comprised of one or more partnerships or S corporations all of which have the same taxable year.

Forthcoming temporary regulations will provide that the initial determination of whether an entity is part of a tiered structure will be made as of the day that entity makes a section 444 election. In addition, the forthcoming temporary regulations will provide that if an entity that has made a section 444 election subsequently becomes part of a disqualifying tiered structure, such entity will be required to change to its required taxable year. Finally, the forthcoming regulations will address the meaning of the term "tiered structure."

VIII. Calculation of Required Payment

Section 7519(b) of the Code defines the amount of payment required of a partnership or S corporation making a section 444 election. Under section 7519(b), the required payment with respect to an applicable election year is an amount equal to the excess of a product specified in section 7519(b)(1) over "the amount of the required payment for the preceding applicable election year" specified in section 7519(b)(2).

Forthcoming temporary regulations will define the required payment with respect to an applicable election year as the amount equal to the excess of (a) the product specified in section 7519(b)(1) for such year over (b) the cumulative amount of required payments for all preceding applicable election years (reduced by the cumulative amount of payments refunded under section 7519(c) for all such preceding years). Such an interpretation is necessary in order to effectuate the intent of Congress regarding this provision. Absent this clarifying interpretation, the amount of required payments made by electing partnerships and S corporations under section 7519(b) could be significantly greater than the amount of such payments contemplated by Congress as representing the value of the tax deferrals obtained by those entities through the use of a taxable year that is different from their required taxable year.

IX. Refund of Required Payments

Section 7519(c) of the Code effectively provides that any partnership or S corporation is entitled to a refund of the required payment if the amount of the required payment for the preceding applicable election year as specified in section 7519(b)(2) exceeds the amount of a product specified in section 7519(b)(1). (See section VIII of this notice regarding the determination of the amount of the required payment for the preceding applicable election year as specified in section 7519(b)(2)).

Forthcoming temporary regulations will provide that an entity is entitled to a refund of the required payment if (i) the entity terminates its section 444 election; or (ii) the entity liquidates. In addition, a continuing entity that maintains its section 444 election is also entitled to a refund for any applicable election year if the required payment for such year is less than the required payment for the preceding year, as specified in section 7519(b)(2) of the Code (see section VIII of this notice).

X. Treatment of Required Payment

Partnerships and S corporations making a section 444 election are required to make payments to the Federal government under section 7519(b) of the Code. These required payments are not deductible by the partnership or S corporation (or by any other person) for Federal income tax purposes. Rather, these required payments are in the nature of refundable deposits, which do not earn interest. Furthermore, the payments are not passed through to partners or S shareholders. Thus, for example, the required payments made by a partnership are not creditable against the Federal income tax liabilities of partners for any taxable year.

XI. Late Filing of Returns Resulting from a Section 444 Election

A. Returns Resulting from Section 444 Election

Forthcoming temporary regulations will extend the original due date for filing an income tax return that results from making a section 444 election for the first taxable year beginning after December 31, 1986. The due date will be the later of (i) the original due date, or (ii) the due date of the section 444 election. For example, assume a corporation that elected S status for a taxable year beginning in 1986 and ending December 31, 1986, makes a section 444 election to use a September 30 taxable year for its taxable year beginning January 1, 1987. The income tax return for the period January 1 through September 30, 1987, would normally be due December 15, 1987. The forthcoming temporary regulations will extend the original due date of such return to the due date of the section 444 election; therefore, the S corporation should not file a request for extending the original due date of its return.

B. Returns That Must Be Filed if Section 444 Election is Not Made

In many cases, partnerships, S corporations, and personal service corporations will not know whether they qualify or desire to file a section 444 election until forthcoming temporary regulations are issued clarifying various issues. In the event a section 444 election is not made, such partnership, S corporation or personal service corporation will be required to file an income tax return pursuant to section 441(i), 706(b), or 1378 of the Code, whichever applies. In certain cases, such returns may be due prior to the issuance of the forthcoming temporary regulations.

Under forthcoming temporary regulations, the due date for such returns will be the later of (i) the original due date, or (ii) the due date of the section 444 election. No separate extension request need be filed. However, as provided in forthcoming temporary regulations, notification that such extended due date was used will be required with the return.

XII. Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

New Form 8582-CR, Passive Activity Credit Limitations, and Supplemental Instructions for Form 8582, Passive Activity Loss Limitations, will soon be available

Notice 88-11

Two important new items will be issued for use by certain taxpayers who have losses or credits from passive activities.

Form 8582-CR, Passive Activity Credit Limitations, is to be used to compute the amount of credits allowed from a passive activity under section 469 of the Code. The form's separate instructions also contain special rules for computing credits, passed through to partners in publicly traded partnerships.

Supplemental Instructions will be issued for Form 8582, Passive Activity Loss Limitations. They should be used by all affected taxpayers in conjunction with the existing Form 8582 and related instructions. The new instructions will specifically address a number of important issues, including:

(1) How to determine "material participation" as defined in regulations section 1.469-5T;

(2) How to offset gains and losses from the same activity when different forms or schedules are used to report those gains and losses;

(3) How to treat income and loss passed through to partners in publicly traded partnerships;

(4) How to determine modified adjusted gross income for purposes of line 6 of Form 8582 when the taxpayer is subject to the investment interest expense limitation; and

(5) How to apply the passive activity loss phase-in rule in determining investment interest expense when both rental real estate and other passive activities acquired before October 23, 1986, are involved.

Form 8582-CR and the Supplemental Instructions for Form 8582 will soon be printed and will be available in late February from Internal Revenue Service offices. They may be ordered from forms distribution centers at the addresses appearing in the Form 1040 instruction booklet.

Extension of Filing Date for Gasoline Floor Stocks Taxes

Notice 88-12

The due date for reporting the one-time floor stocks tax on gasoline and gasohol has been extended for dealers that have no other excise tax liability during the first quarter of 1988. These dealers now have until April 30, 1988, to report the floor stocks tax on Form 720, Quarterly Federal Excise Tax Return. All other dealers have until April 30 or May 31, on whichever date the return is due, to file Form 720.

This notice supersedes the portions of Proposed Regulations section 48.4081-1(g)(5)(iii) and Notice 813 that stated that dealers having only a floor stocks excise tax liability for the first quarter of 1988 must report the tax on Form 720 by February 16, 1988.

Regardless of when the return is due, all dealers must deposit the floor stocks tax by February 16, 1988, using Form 8109, Federal Tax Deposit Coupon.

The tax is a one-time tax imposed on gasoline and gasohol that was held by dealers on January 1, 1988, and on which no tax under section 4081 of the Internal Revenue Code had previously been paid. It is imposed on dealers who are wholesalers, jobbers, distributors, or retailers. The tax rate is 9 cents a gallon on gasoline and 3 cents a gallon on gasohol.

Under the Technical Corrections Bill of 1987, it is proposed that the additional Leaking Underground Storage Tank (LUST) tax be imposed on floor stocks held by dealers on January 1, 1988, at the rate of 0.1 (1/10) cent a gallon. At this time the Technical Corrections Bill has not been enacted. In the event the Bill is not passed and the tax is paid with the February 16, 1988, remittance, a credit or refund of the LUST tax on floor stocks can be obtained. If no payment of this tax is made and the Technical Corrections Bill is enacted, payment of this tax will be required.

In addition, registered gasohol blenders are reminded that they are eligible to purchase gasoline at a reduced rate of tax (3.33 (3 1/3) cents a gallon plus the LUST tax rate of 0.11 (1/9) cent a gallon) under section 4081(c)(1) of the Code during the first quarter of 1988 only if the gasoline purchased is to be blended with alcohol to produce gasohol. See Notice 88-2, page 473, this Bulletin. Use of registration to purchase gasoline at the reduced rate that is not to be used for blending with alcohol to produce gasohol is misuse of the registration and may lead to revocation of the registration.

Gasoline Credits and Refunds

Notice 88-13

This notice is a reminder that the procedures provided in section 6416 of the Internal Revenue Code of 1986 (Code), relating to credits or refunds of excise tax paid on gasoline, remain in effect. The procedures were not changed by section 1703 of the Tax Reform Act of 1986 (P.L. 99-514, 100 Stat. 277 [1986-3 (Vol. 1) C.B. 691]. This notice only discusses the procedures provided in section 6416 as they relate to the gasoline excise tax imposed under Code section 4081. This notice does not discuss the section 6416 procedures as they relate to other taxes, such as the tax on diesel fuel.

Under section 6416, the person that pays gasoline excise tax to the government under section 4081 may receive a credit or refund of the amount of such tax if the gasoline is later sold or used by any person for any purposes specified in section 6416(b)(2), such as sale for export or a sale to a State or local government for the exclusive use of a State or local government.

Under §48.6416(a)-3(b) of the Manufacturers and Retailers Excise Tax Regulations, this credit or refund is conditioned upon a showing that the person that paid the tax (1) has not included the tax in the price of the gasoline with respect to which it was imposed and has not collected the amount of the tax from the person that purchased such gasoline; (2) has repaid, or agreed to repay, the amount of the tax to the ultimate vendor of the gasoline; or (3) has obtained the written consent of such ultimate vendor to the allowance of the credit or the making of the refund. See §48.6416(b)(2)-3 of the Manufacturers and Retailers Excise Tax Regulations for procedures to be followed and supporting evidence required for obtaining such credit or refund.

These procedures serve as an alternative to those provided in the proposed regulations relating to the gasoline excise tax that were published in the Federal Register on November 18, 1987 (52 FR 44141). Under the proposed regulations, if gasoline is sold at a tax-included price to any person for any purpose described in section 4221(a)(2) (relating to exportation), (a)(3) (relating to vessel or aircraft supplies), (a)(4) (relating to State or local government use), or (a)(5) (relating to nonprofit educational use), a credit or a payment with respect to the gasoline shall be allowed or made to the ultimate purchaser of the gasoline. See §48.6421-3 of the proposed regulations for rules relating to credits or payments to ultimate purchasers of gasoline used for certain exempt purposes.

For any particular transaction, only one of the two procedures described above can be used for the purposes described in the proposed regulations. For example, if a credit or refund is allowed to a taxpayer under section 6416 as to a particular sale of gasoline to a State, then the State cannot also claim a refund under section 6421 as to that purchase of gasoline. The Service anticipates that the regulations under section 6416 will be amended to clarify this point by providing that the person that paid the tax may not receive a credit or refund unless it has received from the ultimate vendor a certification that the ultimate purchaser has agreed not to claim a refund under section 6421.

List of Countries Requiring Cooperation With an International Boycott

Notice 88-14[1]

In order to comply with the mandate of section 999(a)(3) of the Internal Revenue Code of 1954, the Department of the Treasury is publishing a current list of countries which may require participation in, or cooperation with, an international boycott (within the meaning of section 999(b)(3) of the Internal Revenue Code of 1986). The list is the same as the prior quarterly list published in the **Federal Register.**

On the basis of the best information currently available to the Department of the Treasury, the following countries may require participation in, or cooperation with, an international boycott (within the meaning of section 999(b)(3) of the Internal Revenue Code of 1986).

Bahrain
Iraq
Jordan
Kuwait
Lebanon
Libya
Oman
Qatar
Saudi Arabia
Syria
United Arab Emirates
Yemen, Arab Republic
Yemen, Peoples Democratic Republic of

Dated: January 5, 1988.

O. Donaldson Chapoton,
Assistant Secretary for Tax Policy.

---

[1] (Filed by the office of the Federal Register on January 1, 1988, 8:45 a.m., and published in the issue of the Federal Register for January 12, 1988, 53 F.R. 771)

Estimated Taxes—Payments by Trusts and Certain Estates

Notice 88-15

On April 27, 1987, the Internal Revenue Service (IRS) published Notice 87-32 in 1987-1 C.B. 477. That notice informed taxpayers that the IRS will, under certain circumstances, waive the addition to tax for underpayments of estimated tax by trusts and estates. This notice informs taxpayers of the procedure to be used to obtain such a waiver.

Taxpayers whose underpayments, prior to July 1987, resulted from changes made by the Tax Reform Act of 1986 should file Form 2210, Underpayment of Estimated Tax by Individuals and Fiduciaries, with their return or amended return. The trustee or executor should write the word "waiver" in the left hand margin of Form 2210 and attach a statement explaining that no penalty should be assessed because the underpayment is due to changes made by the Tax Reform Act of 1986.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Gasoline Excise Tax — Regulations

Notice 88-16

The purpose of this notice is to inform taxpayers and other affected persons of changes that the Internal Revenue Service intends to make in regulations ("the proposed regulations") recently proposed under sections 4081-4083, 4101, 6421, and 6427 of the Internal Revenue Code ("the Code"). The proposed regulations would implement amendments to these provisions enacted by section 1703 of the Tax Reform Act of 1986 (P.L. 99-514, 100 Stat. 2774) [1986-3 (Vol. 1) C.B. 691] ("the Act"). The proposed regulations were published in the Federal Register on November 18, 1987 (52 FR 44141). The amendments made by section 1703 of the Act were effective on January 1, 1988.

As amended by the Act, section 4081 of the Code generally provides that the gasoline excise tax is imposed on the earlier of the removal or sale of gasoline by the refiner or importer thereof or the terminal operator. Section 4082 of the Code provides that the term gasoline includes, to the extent prescribed in regulations, gasoline blend stocks ("blend stocks") and products commonly used as additives in gasoline ("additives").

Except as specifically provided otherwise in this Notice, all of the anticipated changes in the proposed regulations described in this Notice will be effective January 1, 1988.

I. *Bulk Transfers*

Paragraph 48.4081-1(a)(1) of the proposed regulations provides that tax is not imposed "on a removal or sale of gasoline pursuant to a bulk transfer of gasoline between a registered taxpayer and another registered taxpayer . . . " Paragraph 48.4081-1(e)(2) defines bulk transfer as "any transfer of gasoline from one location to another by pipeline tender or marine delivery (i.e., transfer by barge or tanker) of no less than 10,000 barrels."

Final regulations will provide that a transfer of any volume of gasoline will qualify as a bulk transfer if such transfer is by pipeline or marine gasoline transporting vessel from a refinery, customs custody, or terminal to a refinery or terminal. For purposes of determining whether a transfer is a bulk transfer, a facility will qualify as a terminal only if it has a storage capacity of at least 10,000 barrels. The term marine gasoline transporting vessel will include a tanker, inland tanker barge, or offshore loadline barge having cargo compartments in which gasoline is transported.

Final regulations also will clarify that the reference in paragraph 48.4081-1(a)(1) of the proposed regulations to a "bulk transfer of gasoline between a registered taxpayer and another taxpayer" does not mean that tax is imposed on a removal pursuant to a bulk transfer (as defined in the preceding paragraph) of gasoline between facilities of the same registered taxpayer. No tax is imposed on a removal pursuant to such a bulk transfer.

II. *Exchanges Made Simultaneously with Removals*

Paragraph 48.4081-1(a)(1) of the proposed regulations provides that tax is not imposed on a "qualified sale." Paragraph 48.4081-1(e)(9) of the proposed regulations defines "qualified sale" as

> any transfer of title to or possession of gasoline between persons registered under section 4101, including exchanges or consignments of gasoline, when the gasoline is not transferred from one location to another (such as an exchange of title while the gasoline remains stored in a terminal).

The Service is concerned that this definition may not cover exchanges in which title is transferred simultaneously with a removal of the gasoline by the person receiving title in the exchange or by that person's customer. Therefore, final regulations will provide that a "qualified sale" includes an exchange of title to gasoline in a terminal between registered taxpayers that takes place simultaneously with a removal of the gasoline by the taxpayer receiving title to the gasoline or by a customer of that taxpayer, provided that such exchange is in accordance with normal industry practice, and provided that the party transferring title to the gasoline maintains records of the identity and registration number of the party receiving the gasoline, the date of the exchange, and the volume and type of gasoline exchanged. It is normal industry practice that exchanges are made in-kind, and that not more than an insubstantial portion of the exchange be settled in cash or property other than gasoline.

The treatment of exchanges as qualified sales may be illustrated by the following example. Assume that registered refiner A owns previously untaxed gasoline stored in a terminal in California, while registered refiner B owns previously untaxed gasoline stored in a terminal in Maryland. Assume that A wishes to sell a truckload of gasoline to wholesale distributor X located in Maryland. Pursuant to an exchange agreement with A and in accordance with normal industry practice, B permits X to withdraw a truckload of gasoline owned by B from the terminal in Maryland. X pays or will pay A for the gasoline. Pursuant to the exchange agreement, B receives the right to receive (or to transfer to B's customer) an equal volume of gasoline owned by A. B maintains records showing the identity and registration number of A, the date and place of the exchange, and the volume and type of gasoline exchanged. On these facts, B is not required to pay tax on the transfer of title to gasoline to A; however, A must pay tax on the sale of the gasoline to its customer X.

III. *Blend Stocks and Additives*

A. *Products Requiring Further Processing*

Final regulations will clarify that the term "blend stocks" as defined in paragraph 48.4081-1(e)(5) of the proposed regulations does not include any product that cannot be blended into gasoline without further processing or fractionation. Thus, no tax is imposed on a sale or removal of a mixed hydrocarbon stream produced by a natural gas plant that cannot be blended into gasoline in the stream's form at the time of sale or removal, even though further processing of the stream may produce products, such as butane, that can be blended into gasoline.

Similarly, the term "additives" as defined in paragraph 48.4081-1(e)(8) of the proposed regulations does not include any product that cannot be used as an additive without further processing. Thus no tax is imposed on the sale of a chemical that cannot itself be used as a gasoline additive, even though such chemical can be used to make another product that can be used as a gasoline additive.

B. *Products to be Listed in Forthcoming Revenue Ruling*

The Service is concerned that the definitions of the terms "blend stock" and "additives" contained in the proposed regulations do not permit taxpayers to determine with certainty whether certain products fit within these definitions. Therefore, the Service intends to list by revenue ruling (or other administrative pronouncement) specific products that will, and specific products that will not, be considered to be blend stocks or additives.

Until the issuance of this revenue ruling, taxpayers may rely on the rules described below in sections C and D of this part III of this Notice to treat as tax-free certain sales and removals of any product that might be considered a blend stock or additive under the definitions included in the proposed regulations. Such rules will continue to apply after issuance of this revenue ruling to permit tax-free treatment of certain sales and removals of products that are specifically listed as blend stocks or additives in this revenue ruling, or that are not listed in this revenue ruling. Final regulations will include rules identical to or similar to these rules to permit tax-free sales of such products.

Whether a product that is not specifically listed in this revenue ruling will be considered a blend stock or additive will be determined under definitions provided in regulations.

C. *Purchases and Removals of Blend Stocks and Additives by Certain Registered Persons*

No tax will be imposed on any sale of blend stocks or additives to, or removal of blend stocks or additives by, a registered person, provided the transferor is registered and maintains records of the identity and registration number of the transferee, the date and location of the transfer, and the volume and type of product transferred. Such a sale or removal will be tax-free regardless of the means by which the blend stock or additive is transferred and regardless of the volume transferred. Thus, a transfer by tank car or truck may be tax-free under this rule. This rule applies only to blend stocks and additives. It does not apply to any product that constitutes gasoline within the meaning of paragraph 48.4081-1(e)(4)(i) of the proposed regulations.

Final regulations will provide that an industrial user may register as a terminal operator to purchase gasoline blend stocks or additives tax-free, even if such purchase would not constitute a bulk transfer. (The references to "bulk quantities" in the last sentence of paragraph 48.4081-1(e)(15) of the proposed regulations, to "bulk transfer" in the second sentence of paragraph 48.4081-1(e)(7) of the proposed regulations, and to "bulk quantities" in the next to the last sentence of paragraph 48.4101-1(a)(1) of the proposed regulations will be revised to reflect this change.) Therefore, an industrial user as defined in the first sentence of paragraph 48.4081-1(e)(7) of the proposed regulations that has registered as a terminal operator may purchase blend stocks and additives tax-free regardless of the quantity of product involved and regardless of the means of transportation by which such industrial user receives such blend stocks or additives.

D. *Purchases and Removals of Blend Stocks and Additives by Certain Other Persons*

A registered person may sell a blend stock or additive tax-free to any person, whether or not registered, provided that (1) the registered person in the normal course of its business maintains on file copies, for at least three years from the date of the transaction, of invoices of sales of blend stocks and additives showing the name of the purchaser, the date of purchase, and the type and volume of product purchased, (2) the registered person obtains from the purchaser a certification, in the form provided below, regarding the use of the product, (3) the certification is either attached to or appears on the invoice for the sale, (4) the registered person provides a disclosure statement to the purchaser in the form provided below, (5) the district director has not determined that the registered person may not make tax-free sales of additives or blend stocks under this rule, and (6) such blend stock or additive is not listed in a revenue ruling (or other administrative pronouncement) as ineligible for tax-free sale under this rule. No such revenue ruling has yet been issued. Therefore, at this time any blend stock or additive may be sold tax-free under the rule of this section D, provided that the required certification is obtained. The effect of any revenue ruling making any product ineligible for sales tax-free under the rule of this paragraph will be prospective only.

A registered person is not required to obtain any certification from a registered purchaser, since a registered person may purchase blend stocks or additives tax-free under section C of this part III. An unregistered person that purchases blend stocks and additives tax-free under the rule of this section D must agree that, if the products are resold to an unregistered person, a certification in the form provided below will be obtained from the purchaser. The certification is to be attached to or appear on the invoice for the resale. No certification need be obtained, however, if the product (1) is resold with the expectation that it will not be used for blending with or adding to gasoline subject to tax under section 4081, and (2) is resold in packages of drum quantity (55 gallons) or less (if the product is a gasoline blend stock), or in packages of gallon quantities or less (if the product is an additive).

The rule of this section D applies only to blend stocks and additives and does not apply to any product that constitutes gasoline within the meaning of paragraph 48.4081-1(e)(4)(i) of the proposed regulations.

A district director has the authority to deny to any registered person the right to sell blend stocks and additives tax-free under the rule of this section D if the district director determines that the district director cannot verify the accuracy of, or compliance with the terms of, any certificate obtained by such registered person, or by any person purchasing tax-free any product that was originally sold by such registered person. Any action by the district director under this paragraph shall be prospective only and shall not result in the imposition of tax on any previous sale.

The certification shall take the following form:

"The undersigned purchaser ("I" or "me") hereby certifies that the product shown on this invoice will not be used by me for blending with or adding to gasoline (other than to produce a fuel taxable under section 4041(b)(2) or (m)).

"I have received a disclosure statement from the seller describing my legal obligations under this certification. I have read the disclosure statement and agree to the terms described in it.

"I understand that any fraudulent use of this certification to purchase any product free of tax will subject me to penalties of perjury, which may include fine and imprisonment.

"Signature of purchaser________

Date______________

Taxpayer identification number of purchaser_________________

Address of purchaser__________

The disclosure statement shall take the following form.

"If you are an unregistered person who buys a blend stock or additive tax-free based on a certification that you will not use the product for blending with or adding to gasoline, and you then use the product for that purpose, you may be subject to penalties if you do not satisfy applicable registration requirements before incurring any liability for tax resulting from such use.

"You must be prepared to establish by satisfactory evidence the purpose for which you used a blend stock or additive purchased tax-free.

"You can purchase a blend stock or additive tax-free for resale only if you maintain on file, for at least three years from the date of the transaction, in the normal course of business, copies of invoices showing the names of purchasers, the date of purchase, and the type and volume of product sold. If you resell the product to an unregistered person, you must obtain on, or attached to, the invoice for any resale a certification from the purchaser in the same form as the certification you signed when you bought the product tax-free, and you must also give the purchaser a disclosure statement in the same form as this disclosure statement. No certification need be obtained and no disclosure statement need be provided, however, if the product (1) is resold with the expectation that it will not be used for blending with or addint to gasoline subject to tax under section 4081 of the Internal Revenue Code, and(2) is resold in packages of drum quantity (55 gallons) or less (if the product is a gasoline blend stock within the meaning of section 4082(a)(1)), or, in packages of gallon quantity or less (if the product is an additive to gasoline within the meaning of section 4082(a)(2)).

"If you resell the product that you bought tax-free to a registered person, you must obtain, attached to or on the invoice, a statement signed by the purchaser under penalties of perjury that the purchaser possesses a valid Certificate of Registry (Form 637), and giving the number of such Certificate."

IV. *Fuels Described in Section 4041*

Final regulations will clarify that the term "gasoline", as defined in paragraph 48.4081-1(e)(4) of the proposed regulations, does not include any methanol or ethanol fuel described in section 4041(b)(2) or (m).

V. *Registration and Bond*

As provided in I.R.S. Notice 87-83, 1987-2 C.B. 393, Certificates of Registry issued prior to January 1, 1988, and Certificates of Registry issued after January 1, 1988, to registrants that used old Form 637 to register, will be revoked on March 31, 1988. Therefore, all such persons that are subject to the registration requirements contained in the proposed regulations and this Notice will be required to reregister. Under Notice 87-83, the effective date of the bond requirements was delayed until April 1, 1988. The bond requirement applies to all persons required to register under section 4101 of the Code, including any person that registered on new Form 637 (Rev. October 1987) for the first quarter of 1988 that was not required to give a bond at the time of such registration.

Paragraph 48.4101-1(b)(2) of the proposed regulations requires that applications for registry include evidence of financial responsibility. In order to satisfy this requirement, the district director will determine whether the applicant has a satisfactory filing, deposit, and payment history. The district director will examine the applicant's filing, deposit, and payment history in all areas of federal taxation, including income, employment, and excise taxes for either the preceding eight quarters (for taxes due on a quarterly basis) or the preceding two years (for taxes due on an annual basis) to determine if the applicant has filed tax returns and made deposits and payments of tax in a timely manner. Generally, if the district director is satisfied with the applicant's filing, deposit, and payment history, no bond will be required of the applicant under sections 4081 and 4101. If the district director is not satisfied with the filing, deposit, and payment history of the applicant, or no such history exists (*e.g.*, in the case of a newly created business), a bond will be required. Under extenuating circumstances however (*e.g.*, bankruptcy of the applicant), the district director may waive the bond requirement and accept an alternative form of security.

If a bond is required, the amount of the bond will be equal to the lesser of (1) $1,000,000 or (2) the amount of tax that would be imposed under section 4081 on the expected volume of gasoline that will be removed or sold by the applicant during an average 1-month period (as determined by the district director) as if all such removals or sales are taxable. This may require a bond from some persons that do not expect to incur any tax liability under section 4081, and therefore would not have been required to give a bond (other than the minimum amount) under the proposed regulations. This portion of the proposed regulations will be issued in proposed form before being issued in fianl form.

If a bond is required of a for-hire terminal operator (*i.e.*, a terminal operator that does not own any gasoline in its terminal), the bond will be equal to the lesser of (1) $500,000 or (2) the amount of tax that would be imposed under section 4081 on the expected volume of gasoline that will flow through the terminal operator's equipment or facility (as if the terminal operator were the owner of all such gasoline) during an average 1-month period (as determined by the district director).

If a bond is required, the surety on the bond must be a company approved for inclusion on the Department of the Treasury Circular 570 as an acceptable surety or reinsurer on Federal bonds. Any other company or individual cannot be a surety for purposes of a bond required under sections 4081 and 4101.

The final regulations will provide that a registrant that is required to give a bond may apply to the district director for the release of the bond, based on a showing of satisfactory filing, deposit, and payment history.

VI. *No Tax Imposed on Sales of Previously-Taxed Gasoline*

The final regulations will clarify that no tax is imposed on the removal or sale of gasoline previously subject to tax. However, gasoline will not be considered "previously subject to tax" if a refund is claimed with respect to such gasoline.

VII. *Transition Rule for Sales Before Date of This Notice*

A credit or refund may be claimed for a removal or sale of gasoline between January 1, 1988, and January 29, 1988, that is taxable under the proposed regulations but is not taxable pursuant to this notice, and on which tax was paid, such as a sale of 8500 barrels of gasoline by pipeline.

VIII. *Verification of Registration*

The Service will provide by revenue procedure (or other administrative pronouncement), a verification procedure whereby a transferor of gasoline or a terminal operator will be able to ascertain whether a registration number is current and valid. Until such time, the procedures provided in Notice 87-83, 1987-2 C.B. 393, remain in effect.

Clarification as to the Applicable Dollar Limitation For the Use of the Vehicle Cents-Per-Mile Rule For 1987 Under Section 61

Notice 88-17

Under section 61(a) of the Internal Revenue Code of 1986, gross income includes fringe benefits provided to individuals as compensation for services. Income Tax Regulation §1.61-2T sets forth the general rules on the taxation of fringe benefits to individuals as well as the available methods of valuation of such fringe benefits. Section 1.61-2T(e) of the Income Tax Regulations discusses the availability of the vehicle cents-per-mile valuation rule for the valuation of the use of an employer-provided vehicle. The regulations provide that the vehicle cents-per-mile valuation rule may not be used for a vehicle whose fair market value exceeds the dollar limitation determined under §1.61-2T(e)(1)(iii). That limitation is currently defined in the regulation as "the sum of the maximum recovery deductions allowable under section 280F(a)(2) for the first three taxable years in the recovery period for an automobile first placed in service during that calendar year." For 1985 and 1986, that value was $12,800. Section 201(d)(4)(A)(i) and (ii) of the Tax Reform Act of 1986, however, revised the maximum recovery deductions allowable under section 280F(a)(2) (relating to the limitations on the depreciation allowance for luxury automobiles) to reflect the change in the classification of automobiles from 3-year property to 5-year property, effective for property placed in service after December 31, 1986, in tax years ending after such date. Giving effect to the amendments to section 280F(a)(2) in applying the provisions of §1.61-2T(e)(1)(iii) would result in a dollar limitation of $9,110 for the use of the vehicle-cents-per-mile rule in 1987.

Because the statutory change to section 280F(a)(2) was not intended to affect the applicable dollar limitation provided in Income Tax Regulation §1.61-2T(e)(1)(iii), the final fringe benefit regulations will provide that the applicable dollar limitation for 1987 is $12,060. This figure would result if §1.61-2T(e)(1)(iii) had been amended for 1987 to reflect a five year, rather than a three year, recovery period.

The Service will issue further guidance with respect to the appropriate dollar limitations for years after 1987.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Taxable Year of Trusts—Annualization Required for Short Taxable Years

Notice 88-18

Under section 1403 of the Tax Reform Act of 1986 (the Act) all trusts are required to report income on a calendar year basis for taxable years beginning after December 31, 1986. Any trust that, pursuant to section 1403 of the Act, has a short taxable year in 1987 must annualize income earned in the short year. Section 443 and the regulations thereunder provide guidance for annualizing income. Those rules are applicable for purposes of annualizing the income earned by the trust in the short year.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Application of General Utilities Repeal Regulatory Authority to RICs and REITs

Notice 88-19

The Internal Revenue Service intends to promulgate regulations under the authority of section 337(d) of the Internal Revenue Code with respect to the net built-in gain of C corporation assets in connection with transactions or events that result in the ownership of such assets by a regulated investment company (a "RIC") or a real estate investment trust (a "REIT") with a basis determined by reference to the C corporation's basis (a "carryover basis").

Background

Section 337(d)(1) of the Code provides, in part, that the Secretary shall prescribe regulations to prevent circumvention of the purposes of the repeal of the *General Utilities* doctrine through the use of any provision of law or regulations, specifically including the consolidated return regulations and the tax-free reorganization provisions of the Code (part III of subchapter C). The grant of authority includes the authority to issue, or to amend, regulations to ensure that the purposes of the provisions implementing the repeal of the *General Utilities* doctrine (including section 1374, relating to tax imposed on certain built-in gains of S corporations) are not avoided through the use of entities that are not fully subject to corporate taxation, such as RICs and REITs.

Description of Regulations

The regulations will apply with respect to the net built-in gain of C corporation assets that become assets of a RIC or REIT by the qualification of a C corporation as a RIC or REIT or by the transfer of assets of a C corporation to a RIC or REIT in a carryover basis transaction. In cases to which the regulations apply, unless the election described below is made, the C corporation will be treated, for all purposes, as if it had sold all of its assets at their respective fair market values on the relevant date described below and immediately liquidated. Generally, if a corporation is subject to corporate-level taxation under these provisions, the basis of the assets in the hands of the RIC or REIT will be adjusted to their respective fair market values.

In the case of a C corporation that qualifies to be taxed as a RIC or REIT, the regulations will require the C corporation to recognize any net built-in gain (the excess of aggregate gains (including items of income) over aggregate losses) that would have been realized if the corporation had liquidated at the end of its last taxable year before the taxable year in which it qualifies to be taxed as a RIC or REIT. In the case of a C corporation that transfers property to a RIC or REIT in a carryover basis transaction, the regulations will require the transferor C corporation to recognize any net built-in gain that would have been realized if the corporation had liquidated on the day before the date of the transfer. In either case, the regulations will not apply to permit the C corporation to recognize a net built-in loss.

The regulations will permit the transferee RIC or REIT to elect, in lieu of the treatment described above, to be subject to rules similar to the rules of section 1374 of the Code. Section 1374 is currently the subject of proposed technical corrections. The regulations will take into account amendments to section 1374, as appropriate, but will not necessarily include similar effective date provisions. Generally, section 1374 subjects an S corporation to corporate-level taxation on built-in gains recognized within a ten-year period on assets formerly held by a C corporation. The built-in gains of electing RICs and REITs, and the corporate-level tax imposed on such gains, will be subject to rules similar to the rules relating to net income from foreclosure property of REITs. *See* sections 857(a)(1)(A)(ii) and 857(b)(2)(B), (D), and (E).

Transitional Relief

The regulations will take into account the provisions of section 633(d) of the Tax Reform Act of 1986, which provide transitional rules for certain small corporations with respect to the repeal of the *General Utilities* doctrine. The regulations will also provide for appropriate basis adjustments, and other modifications as necessary, if the result of taking such transitional rules into account is the partial recognition of gain.

Scope of Regulations

Except to the extent described in this Notice, the regulations will not affect the characterization for tax purposes of, or the tax treatment of parties to, any transactions to which they apply. For example, shareholders of a C corporation who receive RIC shares in a transaction that qualifies as a reorganization under section 368(a)(1)(C) of the Code will not recognize gain or loss solely because under the regulations the C corporation is subject to corporate-level taxation.

Effective Dates

In the case of carryover basis transactions involving the transfer of property of a C corporation to a RIC or REIT, the regulations will apply to transactions occurring on or after June 10, 1987. In the case of a C corporation that qualifies to be taxed as a RIC or REIT, the regulations will apply to such qualifications that are effective for taxable years beginning on or after June 10, 1987, unless the provisions of subchapter M (relating to RICs or REITs as the case may be) apply to such corporation for the taxable year including June 9, 1987.

These effective dates correspond to the introduction in Congress of legislation to effect technical corrections to the Tax Reform Act of 1986. The Technical Corrections Act of 1987 (introduced June 10, 1987 as H.R. 2636 and S. 1350) would amend section 337(d) of the Code to clarify that the authority of the Secretary to promulgate regulations to prevent the circumvention of the purposes of the provisions of the Tax Reform Act of 1986 that implement the repeal of the *General Utilities* doctrine includes the authority to prevent avoidance of such purposes through the use of RICs or REITs.

Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Allocation of Interest Expense in Connection with Passthrough Entities; Modifications of 1.163-8T

Notice 88-20

BACKGROUND

This notice provides temporary guidance with respect to the allocation of interest expense in connection with certain transactions involving partnerships and S corporations ("passthrough entities") and the allocation of interest expense on debt proceeds received in cash or deposited in a commingled account. Section 1.163-8T of the Income Tax Regulations (T.D. 8145, 52 FR 24,996 [1987-2 C.B. 47] provides rules for allocating interest expense for purposes of applying sections 469 and 163(d) and (h). The regulation provides, in general, that debt is allocated by tracing disbursements of the debt proceeds to specific expenditures and that interest expense on such debt is allocated in the same manner as the debt to which such interest expense relates. Section 1.163-8T does not address the treatment of debt allocated to expenditures for interests in passthrough entities and debt of passthrough entities allocated to distributions by such entities.

EFFECTIVE DATES

In the case of allocations of interest expense on debt allocated to expenditures for contributions to or purchases of interests in passthrough entities, owners of such entities may rely on this guidance for taxable years of such owners ending on or before December 31, 1987. In the case of allocations of interest expense on debt allocated to distributions by passthrough entities, taxpayers may rely on this guidance for taxable years of such entities ending on or before December 31, 1987.

The Internal Revenue Service intends to issue regulations concerning the allocation of interest expense in connection with debt-financed contributions, purchases, and distributions. For taxable years ending after December 31, 1987, such regulations may require the allocation of interest expense in connection with such transactions in a manner different from the manner provided in this notice, without regard to when the debt was incurred.

Section 1.163-8T provides certain rules for tracing debt proceeds received in cash or deposited in a commingled account (i.e., an account containing both debt proceeds and unborrowed funds, or the proceeds of two or more debts). This notice modifies those rules with respect to debt proceeds deposited in an account of the taxpayer or received in cash on or before December 31, 1987.

TREATMENT OF DEBT OF OWNERS OF PASSTHROUGH ENTITIES ALLOCATED TO EXPENDITURES FOR CONTRIBUTIONS TO OR PURCHASES OF INTERESTS IN SUCH ENTITIES

In the case of debt proceeds allocated under §1.163-8T to the purchase of an interest in a passthrough entity (other than a purchase in which the entity receives proceeds from the purchase), the debt proceeds and the associated interest expense shall be allocated among the assets of the entity using any reasonable method. Reasonable methods of allocating debt among the assets of a passthrough entity would ordinarily include a pro-rata allocation based on the fair market value, book value, or adjusted basis of the assets, reduced by any debt of the passthrough entity or the owner allocated to such assets.

Interest expense on debt proceeds allocated under §1.163-8T to a contribution to the capital of a passthrough entity may be allocated using any reasonable method. Reasonable methods would ordinarily include allocating the debt among the assets of the entity or tracing the debt proceeds to the expenditures of the entity under the rules of §1.163-8T as if the contributed debt proceeds were the proceeds of a debt incurred by the entity. For purposes of this notice, a purchase of an interest in a passthrough entity will be treated as a contribution to the capital of the entity to the extent that the entity receives proceeds from the purchase.

TREATMENT OF DEBT OF PASSTHROUGH ENTITIES ALLOCATED TO DISTRIBUTIONS BY SUCH ENTITIES

Debt of passthrough entities and the associated interest expense is generally allocated under the rules of §1.163-8T. In the case of debt proceeds of passthrough entities used to make distributions to the owners of the entity, the debt proceeds and associated interest expense may, at the option of the entity, be allocated among the expenditures (other than distributions) of the entity during the taxable year, to the extent that debt proceeds have not otherwise been allocated to such expenditures.

If, notwithstanding the optional allocation authorized in the preceding paragraph, debt proceeds of a passthrough entity are allocated to distributions to owners of the entity, each owner's share of the associated interest expense shall be allocated, under the rules of §1.163-8T, in accordance with the use of the debt proceeds distributed to such owner. To the extent that an owner's share of such interest expense exceeds the passthrough entity's interest expense on debt proceeds distributed to such owner, any reasonable method may be used to allocate the excess interest expense.

Paragraph (d) of §1.163-8T provides rules governing the treatment of debt repayments. Any repayment of debt of a passthrough entity allocated to distributions and to one or more other expenditures may be treated first as a repayment of the portion of the debt allocated to such distributions.

MODIFICATION OF SINGLE ACCOUNT AND 15-DAY RULES

Paragraph (c)(4)(iii)(B) of §1.163-8T provides, among other things, that a taxpayer may treat any expenditure made from an account within 15 days after debt proceeds are deposited in such account as made from such proceeds to the extent thereof. Paragraph (c)(5)(i) of §1.163-8T provides a similar rule with respect to debt proceeds received in cash. Paragraph (n)(2) of §1.163-8T provides that in the case of expenditures made before August 4, 1987, these rules are applied by substituting 90 days for 15 days.

The Internal Revenue Service intends to issue regulations providing that for debt proceeds deposited in an account on or before December 31, 1987, taxpayers may treat any expenditure made from any account of the taxpayer or from cash within 30 days before or 30 days after (90 days after in the case of expenditures made before August 4, 1987) debt proceeds are deposited in such account or any other account of the taxpayer as made from such proceeds to the extent thereof. Similarly, such regulations will provide that for debt proceeds received in cash on or before December 31, 1987, taxpayers may treat any expenditure made from any account of the taxpayer or from cash within 30 days before or 30 days after (90 days after in the case of expenditures made before August 4, 1987) debt proceeds are received in cash as made from such proceeds to the extent thereof.

ADMINISTRATIVE PRONOUNCEMENT

This document serves as an "administrative pronouncement" as that term is described in §1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Leaking Underground Storage Tank Tax on Fuel Used on Inland Waterways

Notice 88-21

This notice addresses the tax liability imposed on liquid used as fuel in commercial transportation on inland waterways under section 4042 of the Internal Revenue Code of 1986.

Section 521(a)(3) of the Superfund Amendments and Reauthorization Act of 1986 (the Superfund Act) amended section 4042 of the Code to add to the tax already imposed on any liquid used as a fuel in a vessel in commercial waterway transportation a 0.1 cent a gallon tax to be credited to the Leaking Underground Storage Tank (LUST) Trust Fund. The Superfund Act was signed on October 17, 1986, to be effective January 1, 1987.

Section 1404 of the Harbor Maintenance Act of 1986, signed on November 17, 1986, to be effective January 1, 1987, also amended section 4042 to increase the rate of tax. It sets forth a table that gradually increases the inland waterways tax from 10 cents a gallon before 1990 to 20 cents a gallon after 1994. Because it was expected that the Harbor Maintenance Act would be signed into law before the Superfund Act, section 4042, as amended by the Harbor Maintenance Act, does not contain a LUST tax provision.

Congress is considering a Technical Corrections Bill that would correct the inadvertent omission of the LUST tax provision in section 4042 by providing that, for this purpose, the Superfund Act is to be treated as enacted after the Harbor Maintenance Act. Accordingly, the Bill would reinstate the additional 0.1 cent a gallon tax under section 4042, effective January 1, 1987.

Since legislation under consideration would correct this omission retroactive to January 1, 1987, taxpayers should pay the additional 0.1 cent tax to avoid the possibility of interest payments or the necessity of filing amended returns. If the technical correction as presently proposed is not enacted, a claim may be filed for credit or refund of the LUST tax paid, provided such claim is filed in a timely manner.

Passive Foreign Investment Company Provisions Operation of the Definitional Tests under Section 1296

Notice 88-22

The Internal Revenue Service will issue regulations under the passive foreign investment company provisions of the Internal Revenue Code of 1986 concerning, among other things, the operation of the asset and income tests under section 1296(a) of the Code.

The Internal Revenue Service recognizes the need for taxpayer guidance under the passive foreign investment company provisions, effective for taxable years beginning after 1986, in advance of the publication of the regulations. In particular, taxpayers require guidance concerning the operation of the definitional tests in section 1296(a) of the Code in order to determine whether the foreign corporations in which they hold stock are passive foreign investment companies. A foreign corporation determined to be a passive foreign investment company under section 1296(a) may elect under section 1295 to be a qualified electing fund for its taxable year beginning in 1987. If a foreign corporation makes the section 1295 election and is later determined not to have qualified as a passive foreign investment company during the year for which the election was made, the election will have no effect for federal income tax purposes.

The section 1295 election may be revoked by the PFIC but only with the consent of the Commissioner. The Commissioner's determination will take into account any enactment of technical corrections to the Tax Reform Act of 1986 after the PFIC made the election, as well as provisions of any PFIC regulations published after the PFIC made the election.

Foreign corporations that are calendar year taxpayers must make the section 1295 election before March 15, 1988, in accordance with section 1295(b)(2), to be qualified electing funds for their 1987 taxable years. See the temporary regulations issued under section 1295 for the requirements for making, and the effect of, that election.

The absence of guidance in this document on particular aspects of the definitional tests in section 1296 should not be construed as implying that the regulation will not contain guidance on such matters.

Asset Test

Section 1296(a)(2) of the Internal Revenue code provides that a foreign corporation is a passive foreign investment company if the average percentage of the assets (by value) held by the corporation during the taxable year which produce passive income or are held for the production of passive income ("passive assets") is at least 50 percent of all assets (by value) held by the corporation during the taxable year.

Basis for Asset Test. The regulations will provide that the asset test will be applied on a gross basis. No liabilities, whether secured by particular assets or otherwise traceable to particular assets, will be taken into account.

Average Value of Assets. The average value of assets for the taxable year of the foreign corporation will be the average of the fair market values of the assets determined as of the end of each quarterly period during the taxable year of the corporation. The regulations, in general, will not require that the fair market value of the assets be determined by independent appraisal.

Characterization of Assets. The regulations will establish rules for the characterization of assets as either passive or nonpassive assets. In general, an asset will be characterized as passive if it has generated (or is reasonably expected to generate in the reasonably foreseeable future) passive income as defined in section 1296(b) in the hands of the foreign corporation. Assets held by foreign corporations described in section 1296(b)(2)(A) and (B) that are utilized to produce income in the active conduct of a banking or insurance business will be treated as nonpassive assets. Assets which generate both passive and nonpassive income in a taxable year shall be treated as partly passive and partly nonpassive assets in proportion to the relative amounts of income generated by those assets in that year. The regulations will give specific guidance with respect to certain kinds of assets, including those described below.

Depreciable property used in a trade or business. Any asset that constitutes "property used in the trade or business" within the meaning of section 1231(b) will be considered a nonpassive asset, provided that the trade or business in question is one that does not produce passive income as defined in section 1296(b).

Trade or service receivable. A trade or service receivable will be characterized as a passive or nonpassive asset based on the character of the income derived by the corporation from the transaction that generated the receivable. Accordingly, a trade or service receivable derived from sales or services provided by the corporation in the ordinary course of its trade or business which produce nonpassive income will be treated as a nonpassive asset for purposes of the asset test. The regulations will provide that interest incidentally received on a trade or service receivable that is otherwise treated as a nonpassive asset will not affect the characterization of the receivable.

Intangible assets. Subject to further consideration in prospectively applied regulations, the regulations will provide for the inclusion of intangible assets in testing for passive foreign investment company status. Generally, intangible assets that produce identifiable amounts of income, such as patents and licenses, will be characterized on the basis of the income derived from the intangible assets. Goodwill or going concern value must be identified with a specific income-producing activity of the corporation and characterized as a passive or nonpassive asset based on the income derived from the activity. For purposes of applying the asset test under section 1296(a)(2), intangible assets must be valued according to the guidelines provided in Rev. Rul. 59-60, 1959-1 C.B. 237, as amplified by subsequent revenue rulings published by the Internal Revenue Service.

Working capital. Cash and other current assets readily convertible into cash, including assets which may be characterized as the working capital of an active business, produce passive income, as defined in section 904(d)(2)(A). These assets are, therefore, passive assets for purposes of the section 1296(a)(2) asset test.

Dealer inventory and investment assets. Trading in stock or securities by a foreign corporation for its own account produces passive income. Therefore, under the regulations, stock, securities and other assets related to trading and similar investment activities of a foreign corporation conducted for its own account will be considered passive assets for purposes of the asset test.

The regulations will distinguish the assets of regular dealers in stock and securities held for sale to customers in the ordinary course of their business from the assets held for investment purposes. Any dividend or interest income earned on stock and securities designated as inventory will not affect the characterization of such assets as nonpassive assets.

A foreign corporate dealer's inventory of stock and securities held for sale to customers will be treated as nonpassive assets provided the dealer specifically identifies in its books and records the stock and securities that it holds for sale to customers in the ordinary course of its trade or business and the stock and securities that it holds for investment on its own account. The dealer may not change the initial designation of any share of stock or security as an inventory or an investment asset. Starting 90 days after the publication of this notice, the dealer must specifically identify the inventory and investment assets on the date of acquisition of such assets. If the invesntory assets and investment assets are not properly identified or the corporation changes the characterization of a share of stock or a security, all stock and securities will be treated as passive assets. The quantity of stock and securities identified by the dealer as inventory will be treated as inventory only to the extent it does not exceed the reasonable needs of the dealer's trade or business.

Tax-exempt assets. Securities which produce tax-exempt income, such as municipal bonds, will be characterized as passive assets unless: (1) they represent an appropriately identified inventory asset in the hands of a regular dealer in such securities, or (2) the active banking and insurance exception of section 1296(b)(2) applies.

Income test

Section 1296(a)(2) of the Code provides that a foreign corporation is a passive foreign investment company if 75 percent or more of the gross income of the foreign corporation for the taxable year is passive income. Pursuant to section 1296(b)(1), the term passive income has the same meaning given the term in section 904(d)(2)(A), but without regard to the exceptions provided in section 904(d)(2)(A)(iii). The regulations will provide that the look-through rules of section 904(d)(3) and the regulations issued under that section and section 904(d)(5) will apply to characterize payments received or accrued by the foreign corporation from related controlled foreign corporations and certain related U.S. corporations.

Assets and Income of Subsidiaries

Section 1296(c) of the Code provides that, for purposes of determining whether a foreign corporation is a passive foreign investment company, the foreign corporation is deemed to hold its proportionate share of the assets and to receive directly its proportionate share of the income of its subsidiaries in which it owns 25 percent or more of the stock (determined by value). The regulations will apply this rule to the income and assets of a corporation directly or indirectly owned by the foreign corporation. The rule will apply in the case of an indirectly owned corporation provided the foreign corporation's indirect interest in the lower tier company is at least 25 percent (determined by value).

Effective Date

This document serves as an "administrative pronouncement" as that term is used in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure. See Rev. Rul. 87-138, 1987-2 C.B. 287. Taxpayers may rely on this notice until the regulations are published. The regulations, described in this notice, generally will be effective for taxable years beginning after December 31, 1986. However, any modification of the rules contained in this notice will be prospective.

Ordering Rules for Changes in Methods of Accounting For Purposes of Section 263A

Notice 88-23

The purpose of this notice is to advise taxpayers of an anticipated change in the regulations under section 263A of the Code relating to the ordering rules applicable to changes in methods of accounting for taxable years beginning in 1987. This notice applies only with respect to a taxpayer changing its method of accounting in order to comply with the requirements of section 263A for the first taxable year beginning after December 31, 1986, if, for the same taxable year, the taxpayer also wishes to discontinue its use of the last-in, first-out ("LIFO") method of accounting for inventories.

ORDERING RULES

In general, as provided in section 1.263A-1T(e)(11)(v) of the Income Tax Regulations, the change in method of accounting required by section 263A of the Code shall be deemed to occur (including the computation of the adjustment under section 481(a) of the Code) before any other change in method of accounting is deemed to occur for the year of change. However, forthcoming regulations interpreting section 263A of the Code will modify this rule and provide that, in the case of a taxpayer that wishes to terminate the use of the LIFO method of accounting for inventories, the change from the LIFO method may, if the taxpayer chooses, be made before the change in method of accounting for inventories (and the computation of the corresponding adjustment under section 481(a) of the Code) required by section 263A of the Code is made. In addition, a taxpayer making such change in method of accounting may be permitted to use the expeditious procedure for discontinuing the use of the LIFO method of accounting for inventories contained in Rev. Proc. 88-15, page 683, this Bulletin.

Taxpayers that are required to change their method of accounting for inventories under section 263A, and

(i) are not eligible to utilize the provisions of Rev. Proc. 88-15, or

(ii) have filed a Federal income tax return for the first year beginning after December 31, 1986, before 30 days after the publication of this notice in the Internal Revenue Bulletin, shall be treated as having timely filed for a change in method of accounting to discontinue the use of the LIFO method for their first taxable year beginning after December 31, 1986, if a Form 3115 is filed with the National Office by the later of: (a) the 180th day of the first taxable year beginning after December 31, 1986, or (b) May 6, 1988, 60 days after the publication of this notice in the Internal Revenue Bulletin. Any such request for change in method of accounting shall be considered by the Service under the provisions of Rev. Proc. 84-74, 1984-2 C.B. 736. Reference to this notice and Rev. Proc. 84-74 should be made by either typing or legibly printing the following statement at the top of page 1 of Form 3115: "FILED UNDER NOTICE 88-23 AND REV. PROC. 84-74".

PROCEDURAL INFORMATION

This notice serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Uniform Capitalization Rules as Applied to Farmers

Notice 88-24

This notice provides guidance to taxpayers regarding the application of the uniform capitalization rules to property produced in the trade or business of farming. In addition to a discussion of the general application of the rules, this notice provides safe-harbor values that are available to certain taxpayers with respect to cattle produced in a farming business.

BACKGROUND

Section 263A of the Internal Revenue Code, enacted by the Tax Reform Act of 1986 (Pub. L. 99-514) (the "1986 Act"), provides uniform capitalization rules that apply to the production of property and the acquisition of property for resale. Under those rules, all direct and indirect costs that are allocated to production and resale activities are required to be capitalized by the taxpayer. Capitalized costs are then accounted for by the taxpayer under the various rules contained in the Code regarding the recovery of costs (depreciation, cost of goods sold, etc).

Section 263A generally applies to the production, growing or raising of property in the trade or business of farming if such property (i) has a preproductive period of more than 2 years ("2-year property"); or (ii) is produced by a corporation, partnership, or tax shelter required to use an accrual method of accounting under section 447 or 448 of the Code. (See section 1.263A-1T(c) of the regulations for further guidance regarding these rules). Section 263A generally applies to costs incurred by the taxpayer after December 31, 1986, in taxable years ending after such date.

Section 1.263A-1T(c)(ii) of the regulations, consistent with the legislative history of the Act, provides that in the case of an animal the preproductive period (i) begins at the time of the animal's acquisition, breeding, or embryo implantation, and (ii) ends when the animal becomes productive in marketable quantities or when the animal is reasonably expected to be sold or otherwise disposed of. For example, in the case of a cow raised by a farmer to be used for breeding or dairy purposes, the preproductive period of the cow begins with its conception and ends on the date that the cow drops its first calf. *Accord*, H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 628 (1985).

Taxpayers may use reasonable assumptions and estimates in determining whether animals produced in a farming business have a preproductive period of more than 2 years. For example, assume a taxpayer raises cattle that may be either sold by the taxpayer before the end of the 2-year preproductive period, or alternatively, kept by the taxpayer beyond the 2-year period. Assume also that the taxpayer is not required to use an accrual method of accounting under section 447 or 448, and thus the taxpayer is required to capitalize costs under section 263A only with respect to cattle with a preproductive period of more than 2 years. In determining the cattle that have a preproductive period of more than 2 years, the taxpayer may reasonably estimate, based on past experience and other factors, the percentage of total cattle raised that are reasonably expected to be kept beyond the 2-year period; the provisions of section 263A would then apply to these cattle. Similar estimates may be made by the taxpayer with respect to the sex of cattle that are conceived, but not yet born as of the end of the taxable year.

COSTS TO BE CAPITALIZED

Taxpayers capitalizing costs under section 263A (using the unit livestock method or any other method) must capitalize all direct and indirect costs allocable to the farming property being produced. Costs that are allocable to property being produced include both variable costs that directly correspond to the volume of the taxpayer's production (such as feed), as well as fixed costs which generally do not increase in proportion to the volume of the taxpayer's production (such as depreciation on machinery). Thus, costs required to be capitalized under section 263A are not limited to "marginal" increases in costs attributable to the property being produced, but rather also include portions of fixed costs which are not marginal in nature.

With respect to cattle, costs typically required to be capitalized under section 263A will include the costs of feed (such as grain, silage, concentrates, supplements, haylage, hay, pasture and other forages), breeding, artificial insemination, veterinary services and medicine, livestock hauling, bedding, fuel, lubrication and electricity, hired labor (where applicable), tax depreciation and repairs on buildings and equipment used in raising the cattle (for example, barns, trucks and tractors), farm overhead, taxes relating to any of these items (except for State and Federal income taxes), and interest relating to any of these items (determined, where applicable, under the "avoided cost" method as described in section 1.263A-1T(b)(2)(iv) of the regulations).

In light of the additional costs required to be capitalized under section 263A, taxpayers should not adopt unit prices utilized in the past under the unit livestock method without carefully analyzing whether these unit prices reflect all of the costs required to be capitalized by the particular taxpayer under section 263A.

METHODS AVAILABLE

Certain taxpayers, other than those required to use an accrual method of accounting, may elect not to have the rules of section 263A apply with respect to certain types of property produced in the trade or business of farming. See section 1.263A-1T(c)(6) of the regulations. Taxpayers making the election may (subject to other limitations of the Code) continue to deduct the costs that were deductible under the rules in effect before the enactment of section 263A of the Code.

With respect to taxpayers that do not make the election out of section 263A, section 1.263A-1T(c)(5) of the regulations generally provides that the costs required to be capitalized with respect to farming property may, if the taxpayer chooses, be determined using reasonable inventory valuation methods such as the farm-price method or the unit livestock method. The use of these inventory valuation methods avoids the necessity of accounting for the costs of raising animals by "tracing" and accumulating costs applicable to each separate animal. In addition, under the regulations, these inventory methods may be used by a taxpayer regardless of whether the farming property being produced is otherwise treated as inventory by the taxpayer, and regardless of whether the taxpayer is otherwise using the cash method or an accrual method of accounting. Thus, for example, the unit livestock method may be utilized by a taxpayer in accounting under section 263A of the Code for the costs of raising animals that will be used for draft, breeding or dairy purposes and depreciated (under the rules of section 168 of the Code) when the animal is placed in service.

Notwithstanding a taxpayer's use of the farm-price method or the unit livestock method with respect to farm property to which the provisions of section 263A apply, that taxpayer is not required, solely by such use, to use the same method of accounting with respect to farming property to which the provisions of section 263A do not apply. Thus, for example, assume that Farmer A raises dairy cattle to which the provisions of section 263A apply, as well as cattle that are fed and held primarily for slaughter. Assume also that Farmer A is not a taxpayer required to use an accrual method of accounting under section 447 or 448; thus the provisions of section 263A do not apply to the cattle held by Farmer A primarily for slaughter. (See section 1.263A-1T(c)(1) of the regulations.) Although Farmer A may use the unit livestock method with respect to the dairy cattle, his use of this method does not require Farmer A to use the unit livestock method with respect to the cattle held primarily for slaughter. Instead, Farmer A's accounting for such slaughter cattle is determined under other provisions of the Code and regulations thereunder.

UNIT LIVESTOCK METHOD

Taxpayers not electing to use the safe harbors provided in this notice may use any reasonable inventory valuation method to capitalize the costs of producing property in the trade or business of farming under section 263A. One such reasonable inventory valuation method is the unit livestock method, described in section 1.471-6 of the regulations. Under the unit livestock method, the taxpayer adopts a standard unit price for each animal within a particular class; this standard unit price is used by the taxpayer in lieu of specifically identifying and tracing the costs of raising each animal in the taxpayer's farming business. Taxpayers using the unit livestock method must adopt a reasonable method of classifying animals with respect to their age and kind so that the unit prices assigned by the taxpayer to animals in each class are reasonable. Thus, taxpayers using the unit livestock method typically classify cattle based on their age (for example, a separate class will typically be established for calves, yearlings and 2-year olds).

Under section 1.471-6 of the present regulations, taxpayers using the unit livestock method may not subsequently change the classification or unit costs they intially adopted without obtaining the approval of the Commissioner. (Taxpayers who were, however, using the unit livestock method prior to the effective date of section 263A are required to change automatically their method of accounting, including their unit costs, to reflect the additional costs required to be capitalized under sectin 263A. See section 1.263A-1T(e)(11) of the regulations.) Forthcoming regulations will modify this rule contained in section 1.471-6 and require that taxpayers adjust the unit prices upward, from time to time as specified by those regulations, to reflect increases in costs taxpayers experience in raising livestock. Any other changes in the classification or unit prices used in the unit livestock method will continue to be allowed only with the consent of the Commissioner.

In addition, section 1.471-6 of the current regulations provides that no increase in unit cost is required under the unit livestock method with respect to the taxable year in which certain animals are purchased, if such purchases occur in the last six months of the taxable year. The temporary regulations under section 263A, published in the Federal Register on March 30, 1987, (52 FR 10052, T.D. 8131) amend this rule and provide that any tax shelter required to use an accrual method of accounting under section 448 must include in inventory the annual standard unit price for all animals purchased during the taxable year, regardless of when in the taxable year such purchases are made. See section 1.263A-1T(c)(5)(ii) of the regulations. Forthcoming regulations will further amend this rule, and require that all taxpayers using the unit livestock method must modify the annual standard price in order to reasonably reflect the particular period in the taxable year in which purchases of livestock are made, if such modification is necessary in order to avoid significant distortions in income that would otherwise occur through operation of the unit livestock method. Such amendments will be effective for taxable years beginning after December 31, 1987. The regulations will not specify the particular modification that shall be made to the annual standard price for any particular taxpayer, but rather shall allow any reasonable modification made by the taxpayer to the annual standard price to avoid significant distortions in income. For example, assume a taxpayer purchases and raises cattle for slaughter. Assume further that the taxpayer is required to use an accrual method of accounting under section 447 of the Code; thus, section 263A applies to the taxpayer's costs of raising the cattle. Under the forthcoming regulations, the taxpayer may not expense the costs of raising cattle that are purchased in the latter half of the taxpayer's taxable year. Instead, the taxpayer must modify the annual standard price so as to reasonably capitalize the costs of raising the cattle, based on the date of their purchase.

UNIT LIVESTOCK METHOD—SAFE-HARBOR

The legislative history to the 1986 Act evidences a Congressional concern with the potential complexities imposed on farmers under the uniform capitalization rules. In this regard, the discussion of the uniform capitalization rules in the House Ways and Means Committee Report provides that farmers "may determine the costs required to be capitalized by using methods similar to one of the simplified valuation rules of present laws (*e.g.*, the farm-price or the unit-livestock method), in lieu of capitalizing actual costs". H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 629 (1985). *See also* S. Rep. No. 99-313, 99th Cong., 2d Sess. 142 (1986).

In addition, the temporary regulations provide simplified methods of complying with section 263A of the Code. The preamble accompanying those regulations stated that the "regulations provide a simplified method for producers of property in order to reduce the administrative costs of taxpayer compliance with the capitalization requirements of section 263A while preserving the statute's basic purpose to apply uniform capitalization rules to the costs of producing property. The Internal Revenue Service welcomes comments and suggestions as to how the simplified production method may be improved to accomplish those objective most adequately." 52 FR at 10057. In response to this request for comments, several persons have submitted suggestions to the Internal Revenue Service urging the Service to provide for additional simplified methods that would be available to farmers complying with section 263A of the Code.

Based on the foregoing, this notice provides two elective safe harbors that may be used by certain taxpayers in conjunction with the unit livestock method in complying with the capitalization rules of section 263A. Such taxpayers may, at their election, use the safe harbor figures provided in this notice in lieu of independently determining (based on all the applicable facts and circumstances) the amount and timing of section 263A costs to be capitalized with respect to livestock under the unit livestock method or under any other reasonable method.

The safe harbors provided in the notice pertain to the costs of female cattle (to which the provisions of section 263A otherwise apply) raised or purchased by the taxpayer to be used principally (i) for purposes of breeding ("beef cattle"); or (ii) for purposes of producing milk to be sold for consumption ("dairy cattle"). The Internal Revenue Service is aware that the amount and timing of costs to be capitalized under section 263A with respect to beef and dairy cattle may vary depending on the business operations of the particular taxpayer and various other facts. Thus, no inference is intended by the provision of these safe harbors as to the amount and timing of costs to be capitalized by taxpayers not electing the safe harbors provided herein.

The Treasury Department, from time to time, will adjust the safe harbors provided herein to reasonably reflect changes in the costs of producing cattle due to general fluctuations in price indexes and other factors. Any such revisions of these safe harbors will be published by the Internal Revenue Service and will apply to all taxpayers using the safe harbors for taxable years beginning after the date such revisions are published.

Raised cattle.

Taxpayers electing the use of the safe harbor for beef cattle shall capitalize (and decrease the amount of otherwise deductible expenses incurred by the taxpayer) a total of $340 per cow over the following periods: (i) $85 (one-quarter) shall be capitalized in the taxable year in which the cow is born; (ii) $170 (one-half) shall be capitalized in the taxable year following the year in which the cow is born; and (iii) $85 (one-quarter) shall be capitalized in the second taxable year following the year in which the cow is born.

Taxpayers electing the use of the safe harbor for dairy cattle shall capitalize (and decrease the amount of otherwise deductible expenses incurred by the taxpayer) a total of $540 per cow over the following periods: (i) $135 (one-quarter) shall be capitalized in the taxable year in which the cow is born; (ii) $270 (one-half) shall be capitalized in the taxable year following the year in which the cow is born; and (iii) $135 (one-quarter) shall be capitalized in the second taxable year following the year in which the cow is born.

The provisions of these safe harbors apply regardless of when, in the taxable year, the cattle are actually born. Thus, for example, the requirement to capitalize $85 with respect to a beef cow for the first year it is born applies regardless of whether that cow is born in the spring or the fall of the year in question.

In addition, the safe harbors provided in this ruling apply to cattle that were born before January 1, 1987. Assume, for example, that a cash-method farmer raising beef cattle elects to use this safe harbor for his taxable year beginning January 1, 1987. With respect to cattle on hand as of the end of the farmer's taxable year ending December 31, 1987 to which the provisions of section 263A apply, the farmer would capitalize: (i) $85 for each cow born in 1985; (ii) $170 for each cow that was born in 1986; and (iii) $85 for each cow that was born in 1987. For the farmer's 1988 taxable year: (i) no additional amounts would be included in inventory with respect to cows born in 1985; (ii) $85 would be capitalized for each cow born in 1986: (iii) 170 would be capitalized for each cow born in 1987; and (iv) $85 would be capitalized for each cow born in 1988.

Purchased cattle.

In some situations, the provisions of section 263A may apply to taxpayers who purchase beef or dairy cattle from other persons and then raise such cattle to maturity. Taxpayers electing the safe harbors provided in this notice shall treat the date of the cow's purchase as the date of its birth and shall capitalize the greater of (i) the purchase price of such cattle or (ii) the safe harbor amounts provided herein. Thus, for example, assume a taxpayer purchases a beef calf for $40 in 1987. A taxpayer electing the safe harbor for beef cattle would capitalize $85 (the greater of $40 or $85) with respect to the calf for that taxable year. (This treatment would apply regardless of whether the calf was purchased in the first or second half of 1987). Assume, in contrast, that the taxpayer purchases a beef calf for $95. In that case, the taxpayer would capitalize $95 with respect to that calf for that taxable year. The additional amounts capitalized with respect to the calf for subsequent years would follow the schedule applicable to raised cattle, set forth above (*i.e.*, $170 in the second year and $85 in the third year).

ELECTION TO USE SAFE-HARBORS

The safe harbors provided in this ruling may not be used by any corporation, partnership or tax shelter required to use an accrual method of accounting under section 447 or 448. All other taxpayers to which the provisions of section 263A apply may adopt these safe harbors, subject to the requirements of this notice. Taxpayers eligible to use these safe harbors may automatically elect to use them for the first taxable year in which they raise beef or dairy cattle to which the provisions of section 263A apply. Thus, for example, a farmer raising beef or dairy cattle to which the provisions of section 263A apply may automatically elect to use these safe harbors for his first taxable year ending after December 31, 1986 (typically, the calendar 1987 taxable year). Similarly, with respect to a taxpayer who does not raise beef or dairy cattle to which the provisions of section 263A apply until a later year (for example, 1989), that taxpayer may automatically elect the use of these safe harbors for that later year (1989). Taxpayers may elect the use of these safe harbors by using the safe harbor in determining and reporting their taxable income on a timely filed (with regard to extensions) Federal income tax return for the year in question.

Taxpayers electing the safe harbors provided in this notice may not discontinue the use of such safe harbors unless consent to such change in method of accounting is obtained from the Commissioner. In addition, except as otherwise provided in this notice, taxpayers may not elect or adopt the use of these safe harbors unless consent to such change in method of accounting is obtained from the Commissioner.

Taxpayers that elected not to have section 263A apply for 1987.

Taxpayers producing beef or dairy cattle that elected under section 263A(d)(3) of the Code and 1.263A-1T (c)(6) of the regulations not to have the rules of section 263A apply to the costs incurred in a farming business for their first taxable year ending after December 31, 1986, may effectively revoke such election and adopt the use of the safe-harbors provided in this notice (in addition to applying the rules of section 263A to all other applicable plants or animals produced by the taxpayer in a farming business). Taxpayers may revoke the election with respect to their beef or dairy cattle by applying the rules contained in this notice for their taxable year ending in 1987 and by filing an amended return for such year within 180 days after this notice is published in the Internal Revenue Bulletin. Taxpayers that elected under section 263A(d)(3) of the Code not to have the rules of section 263A apply may automatically revoke such election under this notice only for their taxable year ending in 1987 (typically their calendar year).

Taxpayers that applied the rules of section 263A for 1987.

Taxpayers who applied the rules of section 263A by using reasonable methods (other than the safe harbors provided herein) to capitalize the costs of producing cattle for their first taxable year ending in 1987 may elect the use of the safe harbors provided by this notice for (i) their taxable year ending in 1987, or (ii) their taxable year ending in 1988. (For purposes of this notice and section 263A of the Code, in order for a method to be reasonable, a taxpayer must determine the costs to be capitalized based on the particular facts and circumstances of the taxpayer's operations, and not, for example, on the basis of any "safe harbors" other than the safe harbors provided in this notice.) Taxpayers that elect to apply the use of the safe harbors provided in this notice for their taxable year ending in 1987 shall effect such election by filing an amended Federal income tax return for their taxable year ending in 1987 within 180 days after this notice is published in the Internal Revenue Bulletin.

Taxpayers that do not wish to apply the safe harbors until their 1988 taxable year shall apply the safe harbors provided in this notice to the costs of raising cattle in their 1988 taxable year, while adding such safe harbor costs to the costs capitalized under other reasonable methods for their 1987 year. For example, assume a calendar year taxpayer adopted the unit livestock method and applied the rules of section 263A to beef cattle raised by such taxpayer in 1987 by capitalizing x dollars for each cow born in 1987, y dollars for each cow born in 1986 and z dollars for each cow born in 1985. A taxpayer electing these safe harbor rules for 1988 would capitalize an additional $170 with respect to each cow born in 1987 and on hand at December 31, 1988; thus, each cow would have total accumulated capitalized costs of $170 plus x dollars. Similarly, the taxpayer would capitalize an additional $85 dollars with respect to each cow born in 1986 and on hand at December 31, 1988; such cattle would have total accumulated capitalized costs of $85 plus y dollars. Finally, the taxpayer would capitalize $85 with respect to each cow born in 1988 and on hand at December 31, 1988. For all future years, the taxpayer would capitalize costs based on the safe harbor provided in this notice. Taxpayers may utilize the provisions of this paragraph allowing a change to the safe harbors provided in this notice from other reasonable methods of capitalizing costs only for their taxable year ending in 1988. The provisions of this paragraph may not be used for any later taxable year, nor may they be used for changes in 1988 by taxpayers who did not comply with the provisions of section 263A for their taxable year ending in 1987. (For example, the provisions of this paragraph may not be used for changes in 1988 by taxpayers whose method of capitalizing costs under section 263A of the Code for 1987 was unreasonable and not in conformity with section 263A and the regulations thereunder. Such taxpayers, however, may adopt these safe harbors for 1987 by filing an amended Federal income tax return for such year, as provided in this notice).

PROCEDURAL INFORMATION

This notice serves as an "administrative pronouncement" as that term is described in section 1.6661-(3)(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Sections 9201-9204 of the Omnibus Budget Reconciliation Act of 1986

Notice 88-25

The Service will issue proposed regulations under sections 9201-9204 of the Omnibus Budget Reconciliation Act of 1986 (OBRA 1986) that will, in general, provide that no year of service (including years of service before the effective date of the OBRA 1986 provisions) may be disregarded because of the attainment of any age in determining benefits payable to employees from certain employee benefit plans. The proposed regulations are expected to be published in the Federal Register for public comment no later than March 31, 1988.

OBRA 1986 amended the Internal Revenue Code, the Employee Retirement Income Security Act of 1974 and the Age Discrimination in Employment Act of 1967 to require certain employee benefit plans to provide for benefit accruals on behalf of employees without regard to age. The Treasury Department was given primary authority to issue regulations under the OBRA 1986 benefit accrual provisions. Under section 9204(a)(1) of OBRA 1986, the benefit accrual rules "shall apply only with respect to plan years beginning on or after January 1, 1988, and only to employees who have 1 hour of service in any plan year to which such amendments apply."

The proposed regulations will, in general, provide that the OBRA 1986 benefit accrual rules apply to all years of service (including years of service before January 1, 1988) completed by a participant in a defined benefit plan who has at least 1 hour of service in a plan year beginning on or after January 1, 1988, with respect to defined contribution plans, the proposed regulations will provide that the OBRA 1986 accrual rules do not require that retroactive allocations be made to the accounts of participants for plan years beginning before January 1, 1988. However, the proposed regulations will provide that if a defined contribution plan allocates amounts to accounts of participants under a formula that takes prior service into account, all years of service (including years of service before January 1, 1988) must generally be taken into account in determining allocations for plan years beginning on or after January 1, 1988.

Reliance

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure. Taxpayers may rely on this notice until the proposed regulations are published.

Gasohol Blenders—Special 20-day Refund Procedure

Notice 88-26

The purpose of this Notice is to inform gasohol blenders of the special 20-day refund procedure provided in section 6427(i)(3) of the Internal Revenue Code of 1986 ("the Code"). Under this special procedure, gasohol blenders may claim a partial refund of tax paid with respect to gasoline purchased to be blended with alcohol to produce gasohol on which tax was imposed at the 9-1/10 cents a gallon rate provided under section 4081(a) of the Code rather than the 3-4/9 cents a gallon rate of tax provided under section 4081(c)(1).

Under the conditions provided in Notice 88-2, page 473, this Bulletin, registered gasohol blenders are permitted to purchase gasoline for blending to produce gasohol at the reduced tax rate of 3-4/9 cents a gallon. In all other cases, gasohol blenders (like all other purchasers) must purchase gasoline at the rate provided under section 4081(a). If a gasohol blender does not purchase gasoline to be blended to produce gasohol at the reduced tax rate under the conditions provided in Notice 88-2, the special 20-day refund procedure may be used by the blender to claim a refund for the amount of tax imposed under section 4081(a) on the removal or sale of the gasoline in excess of the reduced rate of tax provided under section 4081(c)(1). To claim a refund under this special procedure, such blender must file a claim for refund on Form 843, Claim, with a statement that includes:

a. The name(s) of the supplier(s) of the gasoline and alcohol,
b. date(s) of the purchase(s),
c. total number of gallons of gasoline purchased,
d. total number of gallons of alcohol purchased, and
e. total number of gallons of gasohol produced.

In addition, the claim for refund must be for $200 or more, and only one claim per taxpayer per week will be accepted. If the Service does not process the claim and issue the refund within the 20-day period, interest from the date of the filing of the claim must be paid on the refund amount. Interest will be calculated using the rate and method under section 6621.

A Form 843 may be obtained either from the gasohol blender's local I.R.S. district office or by calling 1-800-424-FORM (3676). Gasohol blenders that qualify and file for the special 20-day refund procedure provided in section 6427(i)(3) must write

"GASOHOL CLAIM" in red beside the title of Form 843 and on the envelope they send to the IRS. The Form 843 must be mailed to a special address at the same Service Center at which the gasohol blender files its tax returns. The special addresses that must be used are provided below:

P.O. Box 16053
Philadelphia, PA 19114
P.O. Box 145500
Cincinnati, OH 45214
P.O. Box 48549
Doraville, GA 30362
P.O. Box 9941, Stop 6552
Ogden, UT 84409
P.O. Box 934, Stop 1005 AUSC
Austin, TX 78767
5045 East Butler Avenue
Fresno, CA 93888
Stop 102
1040 Waverly Avenue
Holtsville, NY 11799
Stop 350, Adj/Corres
310 Lowell Street
Andover, MA 01810
Stop 48, BMF
3131 Democrat Road
Memphis, TN 37501
P.O.Box 24551, Stop 62
Kansas City, MO 64131

As provided in Notice 88-2 and in Notice 88-12, page 481, this Bulletin, the reduced ratio of tax applicable to gasoline removed or sold for blending with alcohol to produce gasohol under section 4081(c)(1) is 3-1/3 cents a gallon plus the Leaking Underground Storage Tank Trust Fund financing rate ("the LUST rate") of 1/9 cent a gallon. The rate of tax applicable to gasohol removed or sold under section 4081(c)(1) is 3 cents a gallon plus the LUST rate of 1/10 cent a gallon.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Original Issue Discount—Treatment of Auction-Rate Debt

Notice 88-27

This notice relates to the treatment under sections 1271 through 1275 of the Internal Revenue Code of certain debt instruments under which the interest rate is reset to a market rate through the use of an auction procedure.

BACKGROUND

Section 1.1275-4 of the proposed original issue discount regulations provides rules for the treatment of contingent payments. The proposed original issue discount regulations were published in the Federal Register on April 8, 1986, 51 FR 12022, 1986-1 C.B. 820.

Since the issuance of the proposed regulations, debt instruments have been issued under which the interest rate is reset to a market rate through an auction procedure, either for a period set by the instrument or, as directed under the instrument, for a period set by the issuer or the holders. Under this auction procedure, as of each auction date, current holders of the instruments may specify (1) that they will continue to hold their instruments; (2) that they wish to sell their instruments at par; or (3) that they will continue to hold their instruments if the new interest rate is no lower than a minimum rate specified by the holder. Prospective purchasers of the instruments must specify the minimum interest rate at which they wish to purchase the instruments at par. The instrument specifies a maximum rate of interest that the issuer will pay on the debt. An independent auction agent determines the lowest rate that is necessary to enable the sale at par of all instruments that current holders wish to sell. The rate so determined is paid to all holders of the instruments until the next auction period. If orders to sell exceed orders to purchase, the interest rate is set at the maximum rate.

TREATMENT OF AUCTION RATE DEBT UNDER THE ORIGINAL ISSUE DISCOUNT RULES

Payments of interest with respect to debt instruments will not be treated as contingent payments within the meaning of section 1.1275-4 of the proposed regulations merely because the interest rate may be reset to a market rate determined through an auction procedure. For this purpose, the interest rate for any period will be considered reset to a market rate if, under the terms of the debt instrument, the interest rate is set at the beginning of the period at the lowest rate that will enable the sale at par of all instruments that current holders wish to sell. The interest rate may be subject to a specified minimum or maximum rate. An interest rate will not be considered reset to a market rate if the procedure for setting the rate is subject to manipulation (e.g., to set interest at other than a market rate or to create a front-loading or back-loading of interest).

Nothing in this notice is intended to suggest whether, or under what circumstances, the resetting of the interest rate on a debt instrument through an auction procedure may constitute a reissuance of the instrument for Federal income tax purposes.

Nothing in this notice is intended to suggest that interest on debt instruments which is reset to a market rate through other procedures will be treated as contingent payments within the meaning of section 1.1275-4 of the proposed regulations.

Because this notice interprets section 1.1275-4 of the proposed regulations, it will not be treated as an administrative pronouncement as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations.

The Service is actively considering the proper application of the original discount rules to debt instruments the interest rate on which is set by auction or by other similar procedures. The Service solicits comments on this matter from interested practitioners and taxpayers.

Estimated Tax Penalty for Farmers

Notice 88-28

This notice provides for the waiver of penalties for underpayment of estimated tax by farmers under certain circumstances. The special estimated tax rules provided for farmers under section 6654(i) of the Internal Revenue Code allow a farmer to make only one required installment of estimated tax for the taxable year on January 15 of the following taxable year. If a farmer files his or her Federal Income Tax Return by March 1 of the following taxable year and pays in full the amount shown as due on the return, no penalty is imposed for not making a payment on January 15.

It has come to the attention of the Internal Revenue Service that many farmers did not timely receive their 1987 Forms 1099-A, Information Return for Acquisition or Abandonment of Secured Property, and/or Forms 1099-G, Statement for Recipients of Certain Government Payments (or substitute Forms CCC-182) from the U.S. Department of Agriculture. Because of this, many farmers will be unable to determine their tax due and file their 1987 income tax returns before the March 1 date, and face estimated tax penalties. Under section 6654(e)(3)(A) of the Code, the Secretary has determined that, due to these unusual circumstances, the imposition of an estimated tax penalty would be against equity and good conscience.

Therefore, the Service will waive any estimated tax penalty for any farmer subject to the special rules under section 6654(i) of the Code who did not receive his or her forms by February 15, 1988. The farmer should attach to Form 1040 a Form 2210F, Underpayment of Estimated Tax by Farmers and Fishermen, and write in the bottom right of Form 2210F "Farm Waiver". The farmer must provide his or her name and social security number on Form 2210F, but should leave lines 1-23 blank.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure. See Rev. Rul. 87-138, 1987-2 C.B. 287.

Inflation Adjustment for Computation of Windfall Profit Tax

Notice 88-29

Section 4989(b) of the Internal Revenue Code requires the determination of an inflation adjustment factor for use in computing the windfall profit tax.

The Service has determined that, for oil removed during the April-June quarter of 1988, the inflation adjustments are as follows:

Tier 1 or Tier 2 oil	0.5257
Tier 3 oil	0.8077

Worksheets for computation of the windfall profit tax are included in the Instructions for Form 6047, Windfall Profit Tax, and an explanation of the inflation adjustment may be found in the Specific Instructions for Line 4 of the worksheets.

Diesel Fuel and Aviation Fuel Taxes Imposed at Wholesale Level

Notice 88-30

This notice describes issues arising from the changes made by section 10502 of the Revenue Act of 1987 (P.L. 100-203, 101 Stat. 1330) ("1987 Act") to the excise tax on diesel fuel and aviation fuel that the Internal Revenue Service intends to address in regulations. The 1987 Act added sections 4091, 4092, and 4093 to the Code, which, beginning on April 1, 1988, move the point of collection of the diesel fuel and aviation fuel tax from the sale by the retailer to the sale by the producer. See section III(B)(1)(a) of this notice regarding the definition of "producer". As a result of this change, tax-free sales below the producer level are no longer allowed, except for fuel destined for use as heating oil and sales to certain categories of purchasers who register and post such bond as the Secretary may require. Thus, many persons who formerly bought these types of fuel tax-free will no longer be able to do so as of April 1, 1988. A credit or refund of all or part of the tax paid may be claimed if the fuel purchased is used for a nontaxable purpose. Conversely, taxable fuel purchased tax-free under section 4093 may be subject to tax if later used in a taxable use or sold by the purchaser in a sale subject to tax under section 4041.

At this time, several legislative proposals that would amend the diesel fuel excise tax are being considered by the Congress. Some of these proposals, if enacted, would alter the collection procedure for the tax for certain types of purchasers, including farmers. If any of these proposals are enacted into law, the Internal Revenue Service will publish additional guidance to implement the changes.

Nothing in this notice is intended to override any agreement or provision of law which takes precedence over the Internal Revenue Code of 1986, as amended.

Table of Contents

I. OVERVIEW
  A. Introduction
  B. Producers
  C. Taxable fuel destined for use as heating oil
  D. Exempt uses
    (1) In general
    (2) Registration and documentation
      (a) In general
      (b) Aviation fuel
      (c) State and local governments
    (3) Bonding
    (4) Cases in which tax-free purchase not available
      (a) Following a taxable sale
      (b) Sales to other persons
  E. Floor stocks tax
  F. Reporting requirements
II. EXEMPTIONS FROM THE TAX
  A. Tax-free sales
  B. Other nontaxable uses
III. REGISTRATION REQUIREMENTS
  A. Who must register
  B. Deadlines for registration
    (1) Importers and producers
      (a) In general
      (b) Sales on or after April 1, 1988, and before May 1, 1988
      (c) Sales on or after May 1, 1988
      (d) Additional information
    (2) Other applicants
      (a) Sales before October 1, 1988
        (i) In general
        (ii) Additional requirements
        (iii) Form of certification
      (b) Sales on or after October 1, 1988
        (i) In general
        (ii) Additional information
        (iii) Form of certification
  C. Additional rules following issue of Certificate
  D. Penalties
IV. HOW TO APPLY FOR REGISTRY
  A. In general
  B. Importers and producers
    (1) In general
    (2) Diesel fuel
    (3) Aviation fuel
  C. Heating Oil Retailers

- (1) Definitions
  - (a) Heating oil retailer
  - (b) Fuel destined for use as heating oil
- (2) Making the application
- (3) Additional requirements

D. Purchaser of fuel for use in a diesel-powered train
- (1) Making the application
- (2) Additional requirements

E. Purchaser of fuel for use in an aircraft not in noncommercial aviation
- (1) Making the application
- (2) Additional requirements

F. Purchaser for fuel for use other than as a motor fuel
- (1) Definitions
  - (a) In general
  - (b) Request for comments
- (2) Making the application
- (3) Additional requirements

G. State or local government
- (1) In general
- (2) Form of certification

V. BOND REQUIREMENTS
- A. In general
- B. Standards for requiring a bond
- C. Amount of bond
- D. Acceptable issuer
- E. Release of Bond

VI. FLOOR STOCKS TAX
- A. In general
- B. Definitions
- C. Inventory
- D. Special rule for determining amount of taxable fuel held in inventory
- E. Requirements with respect to return
  - (1) Form
  - (2) Time and place for filing return
  - (3) Time and place for paying tax
  - (4) Credit or refund
  - (5) Records

VII. REPORTING REQUIREMENTS
- A. Filing requirements
- B. Recordkeeping requirements

VIII. CREDIT AND REFUND PROCEDURES

IX. ADMINISTRATIVE PRONOUNCEMENT

X. DRAFTING INFORMATION

I. OVERVIEW

A. *Introduction*

Prior to April 1, 1988, the tax on diesel fuel and aviation fuel is imposed under section 4041 on fuel sold at the retail level for use in a diesel-powered highway vehicle or in an aircraft used in noncommercial aviation. On or after April 1, 1988, section 4091 imposes the tax on the sale of such taxable fuel by a producer or importer thereof. See section 4091(b) for rates of tax. Section 4092(a) defines "taxable fuel" as diesel fuel and aviation fuel. Diesel fuel is any liquid (other than gasoline) suitable for use as a fuel in a diesel-powered highway vehicle or a diesel-powered train. Aviation fuel is any liquid (other than gasoline) suitable for use as a fuel in an aircraft. A producer is defined in section 4092(b) as a person who is a refiner, compounder, blender, or wholesale distributor, or a dealer selling fuel exclusively to producers, and who elects to register under section 4101 with respect to the tax imposed by section 4091. The term "wholesale distributor" includes any person who sells a taxable fuel to producers, retailers, or to users who purchase in bulk quantities and deliver into bulk storage tanks. A wholesale distributor who also sells taxable fuel at retail may nonetheless qualify as a wholesale distributor under the statutory definition. Furthermore, the term "invoice", as used in this notice, includes an invoice, purchase order, or other record of sale which is maintained by the seller in the normal course of business.

B. *Producers*

Section 4093(b) provides that, under regulations prescribed by the Secretary, the tax imposed by section 4091 shall not apply in the case of sales of a taxabe fuel to a producer of such fuel. The regulations will provide that on or after April 1, 1988, and prior to May 1, 1988, a person may purchase taxable fuel tax-free as a producer of such taxable fuel by following certain procedures, including supplying a certification to the importer or producer selling such fuel. The procedures applicable before May 1, 1988, are described in section III(B)(1)(b) of this notice.

Section III(B)(1) of this notice provides that the regulations will require a producer to register by May 1, 1988, in order to make tax-free sales or purchases on or after that date. Producers that do not have an aceptable filing, deposit, and payment history in all areas of Federal taxation may be required to post a bond. Section V of this notice describes the criteria and requirements for bonding.

C. *Taxable Fuel Destined for Use as Heating Oil*

Section 4093(a) provides that the tax imposed by section 4091 does not apply in the case of sales of any taxable fuel which the Secretary determines is destined for use as heating oil. Section IV(C)(1)(b) of this notice describes how the regulations will define taxable fuel which the Secretary determines is destined for use as heating oil. As explained further in section IV(C), taxable fuel is destined for use as heating oil only if the taxable fuel is to be used by the purchaser as, or sold by the purchaser for, direct consumption as heating oil. Taxable fuel destined for use as heating oil will sometimes be referred to in this notice as "heating oil".

Section 4093(d) grants the Secretary authority to require registration of such persons as the Secretary deems necessary to carry out the subpart. The Secretary has determined to exercise this authority in the case of importers, producers, and retailers of taxable fuel destined for use as heating oil. As explained in section III(B) of this notice, the regulations will provide that importers or producers must register by May 1, 1988, and that heating oil retailers must register by October 1, 1988. Sections IV(B)(1) and (2) of this notice describe how importers and producers of taxable fuel destined for use as heating oil apply for such registration. Section IV(C) of this notice describes how heating oil retailers apply for registration. Such applications should be submitted as soon as possible. See also section III(B)(1) of this notice regarding registration requirements relating to sales and purchases by an importer or producer of taxable fuel destined for use as heating oil on or after May 1, 1988, and procedures to be used until that time. See section III(B)(2) relating to sales and purchases by a heating oil retailer of taxable fuel destined for use as heating oil on or after October 1, 1988, and procedures to be used until that time.

D. *Exempt Uses*

(1) *In general*

Under section 4093(c), the Secretary has authority, subject to such terms and conditions as the Secretary may provide (including registration and bonding), to permit tax-free sales for four specified categories of exempt uses. These categories are:

(a) Diesel fuel for use in a diesel-powered train;

(b) Aviation fuel for use in an aircraft not in noncommercial aviation;

(c) Taxable fuel for use other than as a motor fuel; and

(d) Taxable fuel sold to a state or local government for its exclusive use.

(2) *Registration and documentation*

(a) *In general.* The Secretary has determined to exercise his authority to permit tax-free sales in all four of these categories (collectively, "tax-free purchases" or "tax-free sales") in certain situations and on a case-by-case basis. In general, the regulations will provide that, to make tax-free purchases, all persons eligible for such tax-free purchases, other than a state or local government, must register by October 1, 1988. Once registered, they will be able to make tax-free purchases. Prior to October 1, 1988, however, such persons may make tax-free purchases by following other procedures, including supplying the producer or importer with a certification. Setcion III(B)(2) of this notice describes the procedures applicable to sales or purchases before October 1, 1988 by persons required to register for the sales described in paragraph (1) of this section. Section IV(G) of this notice describes procedures to be followed by state and local governments in order to purchase taxable fuel tax-free. Sections IV(D), (E), and (F) describe how to apply for registration for tax-free purchases of taxable fuel for use in a diesel-powered train, in an aircraft not in noncommercial aviation, and other than as a motor fuel, respectively. Such applications should be made as soon as possible.

(b) *Aviation fuel.* A special rule will apply, however, in the case of importers, producers, and purchasers of aviation fuel for use in an aircraft not in noncommercial aviation. The regulations will provide that a Certificate of Registry (Form 637A) issued pursuant to Chapter 31 of the Internal Revenue Code to a purchaser of aviation fuel for use in an aircraft not in noncommercial aviation or to a person who qualifies as an importer or producer (as definied in section 4092(b)) will apply until further nontice to the tax imposed on aviation fuel under section 4091. Thus, a commercial airline or an importer or producer of aviation fuel already registered on Form 637A may use such Certificate to make tax-free sales or purchases of aviation fuel for use not in noncommercial aviation both before and after October 1, 1988. Any importer, producer, or other purchaser of aviation fuel for use in an aircraft not in noncommercial aviation not so registered must register using Form 637A. See section III(B) of this notice relating to deadlines for registration.

(c) *State and lcoal governments.* The regulations will provide that, until further notice, a state or local government will not be required to register for tax-free sales. See section IV(G) of this notice for rules relating to sales of taxable fuel to a state or local government, including the requirement that the state or local government supply the importer or producer with a certification that all the fuel so purchased is purchased for the exclusive use of the state or local government.

(3) *Bonding*

The regulations will require that persons that are eligible to make tax-free purchases but that do not have an acceptable filing, deposit, and payment history in all areas of Federal taxation may be required to post a bond. Section V of this notice describes the criteria and requirements for bonding. No bonds will be required in the case of state or local governments.

(4) *Cases in which a tax-free purchase not available*

(a) *Following a taxable sale.* A person eligible for tax-free purchases may make a tax-free purchase only if such person purchases the taxable fuel before the section 4091 tax has been imposed. Consider the example of such a person purchasing taxable fuel from a retail dealer. The retail dealer has paid a price for the fuel that includes the tax imposed under section 4091. If the price paid by the person purchasing from the retailer includes the section 4091 tax, the person may file a claim for a credit or refund, as described in section VIII of this notice if the fuel is used in a tax-exempt use. Thus, in the case of any fuel taxable under section 4091, there is *not* available section 6416 (unlike the gasoline excise tax), or any other procedure by which the exempt user may purchase the product tax-free and the seller make a claim for a credit or refund of the tax. In the case of fuel taxable under section 4091, only the exempt user is eligible to make a claim for credit or refund of the tax paid.

(b) *Sales to other persons.* Tax-free sales or purchases for exempt uses are available only for the categoriees set forth in section I(D)(1) of this notice. Sales to other persons for exempt uses, whether or not purchased from a producer, are taxable sales and the exempt user must make a claim for credit or refund of the tax. Exempt uses for which the tax must be paid include:

(i) Off-highway business use;

(ii) Use on a farm for farming purposes;

(iii) Use as supplies for vessels or aircraft;

(iv) Export or shipment to a possession of the United States;

(v) Exclusive use of a nonprofit educational organization;

(vi) Use by certain aircraft museums;

(vii)) Certain helicopter uses;

(viii) Certain intercity, local, and school bus uses; or

(ix) Certain taxicab uses.

Section VIII of this notice describes the credit and refund procedures to be followed by such exempt users.

E. *Floor Stocks Tax*

Section 10502(f) of the 1987 Act imposes a floor stocks tax on any taxable fuel held by a taxable person on April 1, 1988, at the rate of tax which would be imposed if the fuel were sold on that date in a sale subject to tax under section 4091. The floor stocks tax is to be paid before June 16, 1988. The regulations will define taxable fuel as any fuel taxable under section 4091 on which no tax has been imposed under section 4041 and which is not held exclusively for a nontaxable use, as defined in section 6427(l). A taxable person will be defined as any person other than an importer or producer of taxable fuel, as defined in section 4092. The regulations will provide that each taxable person musst prepare an inventory of taxable fuel held on April 1, 1988. The floor stocks tax is discussed further at section VI of this notice.

F. *Reporting Requirements*

The regulations will provide that liability for tax imposed under section 4091 must be reported on Form 720, "Quarterly Federal Excise Tax Return". The regulations will require each person who is registered or requied to register under section 4101 or 4093, and each state or local government purchasing taxable fuel tax-free, to maintain adequate records of all taxable fuel it purchases, sells, or uses. Any person who claims a credit or refund of tax imposed under section 4091 will be required to maintain adequate records to support the credit or refund.

Section 4093(d) gives the Secretary authority to require information reporting as the Secretary deems necessary to carry out the tax imposed by section 4091. Later regulations may require additional recordkeeping and information reporting. See section VII of this notice for more information regarding recordkeeping and reporting requirements.

II. EXEMPTIONS FROM THE TAX

A. *Tax-Free Sales*

Section 4093(b) provides that, under regulations prescribed by the Secretary, the tax imposed by section 4091 shall not apply to sales of taxable fuel to a producer. Under section 4093(a), the tax imposed by section 4091 shall not apply to sales of any taxable fuel which the Secretary determines is destined for use as heating oil. Section IV(C)(1)(b) explains how the regulations will define taxable fuel destined for use as heating oil. The Secretary has authority to require registration of heating oil retailers, and the regulations willl rquire such registration. See sections III and IV of this notice. In addition, under section 4093(c), the Secretary has discretionary authority to permit sales without imposition of the section 4091 tax, in whole or in part, of—

(1) Diesel fuel for use in a diesel-powered train;

(2) Aviation fuel for use in an aircraft not in noncommercial aviation;

(3) Taxable fuel for use other than as a motor fuel; and

(4) Taxable fuel sold to a state or local government for its exclusive use.

The Secretary has determined to exercise this authority on a case-by-case basis and the regulations will so provide. Sections III, IV, and V of this notice give additional information about registration and bonding for such tax-free purchases. Producers and persons wishing to sell or purchase fuel tax-free for these exempt uses, other than a state or local government or a person purchasing taxable fuel for such person's own use as heating oil, must register and post such bond as the Secretary may require. See section III(B) of this notice relating to deadlines for registration. See section IV(G) relating to requirements for state and local governments. In addition, there is no exemption with respect to the Leaking Underground Storage Tank Trust Fund financing rate ("L.U.S.T. tax") for diesel fuel used in a diesel-powered train or aviation fuel. Thus, the term "tax-free", as used in this notice with respect to these uses, does not include the L.U.S.T. tax.

A person eligible for tax-free purchases may make a tax-free purchase only if it purchases the fuel before the section 4091 tax has been imposed. If a person entitled to make tax-free purchases buys fuel on which the section 4091 tax has already been imposed and the price paid by the person includes the section 4091 tax, the person may file a claim for a credit or refund if the fuel is used in a tax-exempt use. For example, such an exempt person, *A*, purchases diesel fuel from a retailer, *B*. *B* paid the tax imposed under section 4091 when *B* purchased the fuel from *C*, a registered producer. The sale of fuel from *B* to *A* is not itself a taxable event, but because the tax has already been imposed, *B* charges *A* a price for the fuel which includes the tax paid by *B* to *C*. If *A* uses the fuel for a tax-exempt use, *A* may claim a credit or refund of tax paid with respect to fuel used for a nontaxable purpose. See section VIII of this notice regarding credits and refunds.

This result in necessary because, in the case of fuel taxable under section 4091, only the ultimate purchaser may claim a credit or refund of the tax paid. Unlike gasoline taxable under section 4081, neither section 6416 nor any other procedure applies to fuel taxable under section 4091 to enable the exempt user to purchase the product tax-free while the seller claims a credit or refund of the tax.

B. *Other Nontaxable Uses*

Under the 1987 Act, all exemptions from the tax (other than those described in paragraph II(A) above) must be realized through a credit or refund procedure following a tax-paid purchase of the fuel. A person may qualify for a credit or refund of the tax paid if the fuel is purchased in or after a taxable sale and is used—

(1) For off-highway business use;

(2) On a farm for farming purposes;

(3) As supplies for vessels or aircraft;

(4) For export or for shipment to a possession of the United States;

(5) By a nonprofit educational organization for its exclusive use;

(6) By certain aircraft museums;

(7) For certain helicopter uses;

(8) In certain intercity, local, and school buses; or

(9) For certain taxicab uses.

See section VIII of this notice for credit and refund procedures.

III. REGISTRATION REQUIREMENTS

A. *Who Must Register*

The regulations will require that every person that is an exempt user eligible for tax-free purchases under section 4093 with respect to fuel taxable under section 4901, other than a state or local government or a person purchasing taxable fuel for such person's own use as heating oil, register in accordance with the applicable provisions of sections III(B) and IV of this notice before buying taxable fuel tax-free. Section 4101 also requires that any person subject to tax under section 4091 register with the Secretary before incurring any liability for tax under such section. See section III(B) of this notice regarding deadlines for registration. See sections IV(E) and III(B)(2)(b) of this notice regarding procedures which apply to a person that already holds a valid Certificate of Registry (Form 637A) as a purchaser of aviation fuel for use in an aircraft not in noncommercial aviation.

B. *Deadlines for Registration*

(1) *Importers and producers*

(a) *In general.* Section 4092(b) defines "producer" as a person who is a refiner, compounder, blender, or wholesale distributor of a taxable fuel, or a dealer selling any taxable fuel exclusively to producers of such taxable fuel, and who elects to register under section 4101 with respect to the tax imposed by section 4091. The term "wholesale distributor" includes any person who sells a taxable fuel to producers, retailers, or to users who purchase in bulk quantities and deliver into bulk storage tanks. The regulations will provide that a wholesale distributor who also sells taxable fuel at retail may nonetheless qualify as a wholesale distributor under the statutory definition.

(b) *Sales on or after April 1, 1988, and before May 1, 1988.* The regulations will provide that on or after April 1, 1988, and before May 1, 1988, taxable fuel may be sold tax-free to a person who (but for not being registered under section 4101) meets the definition of the term "producer" as set forth in section III(B)(1)(a) above, and such person shall be deemed to be a registered producer during this period, provided that—

(i) The seller of taxable fuel to such purchaser in the normal course of its business maintains on file copies of invoices of sales of taxable fuel showing the name of the purchaser, the date of sale, and the type and volume of product sold, and a written statement clearly indicating that the purchaser is a producer who has furnished a certification required by section III(B)(1)(b)(ii) of this notice to the seller, and

(ii) The seller obtains from such purchaser and keeps on file a certification, signed under penalties of perjury by a person having authority to bind the purchaser, stating the name, address, employer identification number of the purchaser, and the title of the person signing the certification. Such certification may cover sales to such purchaser for the period from April 1, 1988, to April 30, 1988, inclusive, and shall take the following form:

"The undersigned purchaser ("Purchaser") hereby certifies that Purchaser is a producer of taxable fuel who is a refiner, compounder, blender, or wholesale distributor of a taxable fuel or a dealer selling any taxable fuel exclusively to producers of such taxable fuel. If Purchaser claims an exemption as a wholesale distributor, Purchaser certifies that Purchaser sells a taxable fuel to producers, retailers, or to users who purchase in bulk quantities and deliver into bulk storage tanks.

"Purchaser understands that any fraudulent use of this certification to purchase any taxable fuel free of tax will subject Purchaser to penalties of perjury, which may include fine and imprisonment."

____

E.I.N.: ______________________

Address: ______________________

____

by ______________________

Title ______________________

The regulations will provide that a person who meets the requirements of this section III(B)(1)(b) shall, for the period beginning April 1, 1988, and ending before May 1, 1988, be deemed to be a registered producer of taxable fuel for purposes of purchasing fuel tax-free as a producer under section 4093(b), and for purposes of incurring liability for the tax imposed by section 4091.

(c) *Sales on or after May 1, 1988.* The regulations will provide that on or after May 1, 1988, taxable fuel may be sold tax-free by a producer or importer of taxable fuel to a producer of taxable fuel under section 4091, but only if—

(i) Both the seller and the purchaser are registered with respect to such sales in accordance with the provisions of section 4101.

(ii) The purchaser has notified the seller in writing with which District Director the purchaser is registered and the Certificate of Registry number of the purchaser, and

(iii) The purchaser's Certificate of Registry number appears on the invoice for each tax-free sale made to the purchaser.

(d) *Additional information.* Applicants are urged to submit applications for registry to the District Director as soon as possible to facilitate the processing of the applications and issuance of registration numbers by May 1, 1988. All approvals of applications to register as an importer or producer submitted on or before April 30, 1988, will be on a conditional basis only. The regulations will provide that the applicant will be furnished a conditional Certificate of Registry (validated Form 637 or Form 637A) ("Certificate") bearing the applicant's temporary registration number. A conditional Certificate is valid until the effective date of any final decision made by the District Director with respect to the application. When a final decision is made, a notice will be sent by the District Director to the applicant stating that (i) the application for registry has received final approval, (ii) the conditional Certificate will expire at a date not less than 60 days after the date of such notice unless a bond is given, or (iii) the Certificate is revoked. Upon final approval of the application and acceptance of the bond, if one is required, the applicant will be furnished a Certificate bearing the applicant's final registration number. See section V of this notice for a description of the criteria and requirements for bonding.

(2) *Other applicants*

(a) *Sales before October 1, 1988*—(i) *In general.* The regulations will provide that taxable fuel may be purchased tax-free from a registered producer or importer on or after April 1, 1988, and before October 1, 1988, if the fuel is—

(*A*) Purchased by a heating oil retailer and is destined for use as heating oil,

(*B*) To be used by the purchaser as fuel in a diesel-powered train,

(*C*) To be used by the purchaser in an aircraft not in noncommercial aviation, or

(*D*) To be used by the purchaser other than as a motor fuel.

(ii) *Additional requirements.* During the period between April 1, 1988, and October 1, 1988, purchasers in sales listed at paragraph (2)(a)(i) of this section are not required to be registered in order for the sale to be tax-free provided that—

(*A*) The importer or producer in the normal course of its business maintains on file copies of invoices of sales of taxable fuel showing the name of the purchaser, the date of sale, and the type and volume of product sold,

(*B*) The importer or producer obtains from the purchaser and keeps on file a certification, in the form provided below and signed under penalties of perjury by a person having authority to bind the purchaser, stating the name, address, employer identification number of the purchaser, the title of the person signing the certification, and the basis for claiming an exemption from payment of the tax imposed under sectin 4091,

(*C*) The invoice for the sale contains a written statement clearly indicating that the entire quantity of the fuel purchased is purchased for the nontaxable use specified in the purchaser's certification, and

(*D*) The District Director has not determined that the purchaser may not make tax-free purchases of taxable fuel under the following paragraph.

These requirements do not apply in the case of fuel purchased by a state or local government for its exclusive use or by a person purchasing taxable fuel for such person's own use as heating oil. Rules that will be contained in the regulations governing the purchase of taxable fuel by a state or local government are set forth at section IV(G) of this notice.

The regulations will further provide that a District Director has the authority to deny to any unregistered purchaser the right to buy taxable fuel tax-free under the rule of the preceding paragraph if the District Director determines that the District Director cannot verify the accuracy of, or compliance with the terms of, any certification provided by such unregistered purchaser. Any such action by the District Director shall be prospective only and shall not result in the imposition of tax on a registered importer or producer with respect to any previous sale of taxable fuel to such purchaser if the importer or producer in good faith accepted a proper certification by the purchaser that the fuel would be used by the purchaser in the exempt manner stated. However, the regulations will also provide that if, at the time of the sale, the importer or producer has reason to believe that any of the fuel sold tax-free by it to the purchaser is not intended to be used for the exempt purpose indicated by the purchaser, the importer or producer is not considered to have accepted the certification from the purchaser in good faith, and is not relieved of liability for the tax imposed on the sale of such taxable fuel under section 4091. An importer or producer has reason to believe that fuel sold by it is not intended for the exempt purposes stated if, for example, the importer or producer is aware that the purchaser does not have the equipment or facilities to use the fuel for the exempt purpose stated, or that the exempt purpose stated is inconsistent with the type of business the purchaser operates. An example of an inconsistent use that indicates acceptance of a certification not in good faith is one in which a producer, while aware that a purchaser's sole business is the operation of a fleet of diesel-powered highway vehicles, nevertheless sells large quantities of taxable fuel to such purchaser for use other than as a motor fuel.

(iii) *Form of certification.* Under the regulations, the certification may cover sales to such unregistered purchaser for the period from April 1, 1988, to September 30, 1988, inclusive, and shall take the following form:

"The undersigned purchaser ("Purchaser") hereby certifies that (a) Purchaser is a __________ [Specify whether purchaser is a heating oil retailer or user of taxable fuel in a diesel-powered train, in an aircraft used in commercial aviation, or other than as a motor fuel], and that (b) the taxable fuel to which this certification relates is purchased for use for the following purpose __________ [State whether sale for use as heating oil, as a fuel in a diesel-powered train, as a fuel in an aircraft not in noncommercial aviation (as defined in section 4041(c)(4) of the Internal Revenue Code of 1986, as amended), or the specific use, in detail, other than as a motor fuel].

"If this taxable fuel is sold or used by Purchaser for a purpose other than as stated above, then Purchaser understands that Purchaser may be subject to tax and may also be subject to penalties if Purchaser does not satisfy applicable registration requirements before incurring any liability for tax resulting from such use. Purchaser will be prepared to establish by satisfactory evidence the purpose for which Purchaser used the product purchased under this certification.

"Purchaser understands that any fraudulent use of this certification to purchase any taxable fuel free of tax will subject Purchaser to penalties of perjury, which may include fine and imprisonment."

E.I.N.: __________

Address: __________

____

____

by __________

Title __________

(b) *Sales on or after October 1, 1988*—(i) *In general.* The regulations will provide that no tax-free sales to any person, other than a producer, a state or local government or a person purchasing taxable fuel for such person's own use as heating oil, of fuel taxable under section 4091 shall be allowed on or after October 1, 1988, unless—

(*A*) Both the seller and the purchaser are registered with respect to such sales in accordance with the provisions of section 4101,

(*B*) The importer or producer obtains from the purchaser and keeps on file a certification, in the form provided below and signed under penalties of perjury by a person having authority to bind the purchaser, stating the name, address, Certificate of Registry number of the purchaser, the title of the person signing the certification, and the basis for claiming an exemption from payment of the tax imposed under section 4091, and

(*C*) The purchaser's Certificate of Registry number appears on the invoice for each tax-free sale made to the purchaser.

See section III(B)(1) of this notice for rules governing sales to registered producers.

(ii) *Additional information.* Applicants are urged to submit applications for registry to the District Director as soon as possible to facilitate processing of the applications and issuance of registration numbers by October 1, 1988. The regulations will provide that, upon approval of the application and acceptance of the bond, if one is required, the applicant will be furnished a Certificate bearing the applicant's registration number. Section V of this notice discusses the criteria and requirements for bonding.

(iii) *Form of certification.* Under the regulations, the certification may cover sales to such a registered purchaser for a period not to exceed 4 calendar quarters, and shall take the following form:

"The undersigned purchaser ("Purchaser") hereby certifies that (a) Purchaser is a registered ____________ [Specify whether purchaser is a heating oil retailer or user of taxable fuel in a diesel-powered train, in an aircraft used in commercial aviation, or other than as a motor fuel], and that (b) the taxable fuel to which this certification relates is purchased for use for the following purpose ____________ [State whether sale for use as heating oil, as a fuel in a diesel-powered train, as a fuel in an aircraft not in noncommercial aviation (as defined in section 4041(c)(4) of the Internal Revenue Code of 1986, as amended), or the specific use, in detail, other than as a motor fuel].

"If this taxable fuel is sold or used by Purchaser for a purpose other than as stated above, then Purchaser understands that Purchaser may be subject to tax and may also be subject to penalties if Purchaser does not satisfy applicable registration requirements before incurring any liability for tax resulting from such use. Purchaser will be prepared to establish by satisfactory evidence the purpose for which Purchaser used the product purchased under this certification.

"Purchaser understands that any fraudulent use of this certification to purchase any taxable fuel free of tax will subject Purchaser to penalties of perjury, which may include fine and imprisonment."

____

Registration No. ____________

Address: ____________

____

____

by ____________

Title ____________

____

C. *Additional Rules Following Issue of Certificate*

The regulations will provide additional rules following issuance of a Certificate. A Certificate, whether conditional or final, may not be transferred from one person to another. A new application for registry will be required, and a bond, if necessary, under the standards set forth in section V of this notice, if there is a substantial change in the ownership or management of a person that holds a Certificate. The regulations will give the District Director authority to revoke a Certificate at any time in a case where the District Director deems it necessary in order to ensure the collection of the tax imposed by section 4091. Any such revocation by the District Director shall be prospective only and shall not result in the imposition of tax on a registered importer or producer with respect to any previous sale of taxable fuel to such purchaser if the importer or producer in good faith accepted a proper certification by the purchaser that the fuel will be used by the purchaser in the exempt manner stated. However, the regulations will also provide that if, at the time of the sale, the importer or producer has reason to believe that the fuel sold by it is not intended to be used for the exempt purpose indicated by the purchaser, the importer or producer is not considered to have accepted the certification from the purchaser in good faith, and is not relieved of liability for the tax imposed on the sale of such taxable fuel under section 4091. See also paragraphs (B)(1) and (2) of this section regarding registration and certification requirements.

D. *Penalties*

Failure to meet the requirements of applicable regulations may result in revocation of a person's registration. See section 7272 for the imposition of a civil penalty for failure to register. See section 7232 for provisions relating to the imposition of criminal penalties for failure to register and give a bond as required by section 4101 or for willfully making any false statement in an application for registry under section 4101.

IV. APPLICATION FOR REGISTRY

A. *In General*

The regulations will provide that application for registry with respect to fuel taxable under section 4091 must be made on Form 637A to make tax-free sales or purchases of aviation fuel, or on Form 637 to register as a producer or to register to purchase diesel fuel or heating oil tax-free. Because Form 637A and Form 637 do not yet reflect changes made to the Internal Revenue Code by the Revenue Act of 1987, the regulations will provide that the applicable form must be prepared in accordance with the instructions and applicable regulations, as modified in this notice.

B. *Importers and Producers*

(1) *In general*

The regulations will provide that an importer or producer of taxable fuel must make separate application for registry with respect to diesel fuel and aviation fuel taxable under section 4091 by May 1, 1988. An importer or producer who sells diesel fuel not destined for use as heating oil as well as taxable fuel destined for use as heating oil must apply for registry as an importer or producer of diesel fuel under the rules below.

(2) *Diesel Fuel*

The regulations will provide that application for registry with respect to diesel fuel must be made on Form 637, "Registration for Tax-Free Transactions Under Chapters 31, 32, and 38 of the Internal Revenue Code". The application must indicate whether the applicant is an importer, refiner, compounder, blender, wholesale distributor, or dealer selling fuel exclusively to producers, and that the applicant qualifies for registry as a producer or importer. Each applicable designation on the form should be checked. If the form does not have a check box which applies to the applicant, check and complete the box, "Other (specify)". The application must specify "DIESEL FUEL" as the type of product bought or sold.

If the applicant also sells taxable fuel destined for use as heating oil, the regulations will provide that the application must specify "DIESEL FUEL AND HEATING OIL" as the type of product bought or sold. As discussed further in section IV(C)(1)(b) of this notice, the regulations will define the term "fuel destined for use as heating oil" as taxable fuel (a) purchased for use by the purchaser as heating oil, or (b) purchased by a registered importer, producer, or heating oil retailer for sale to a third party for use as heating oil by such third party. The term "fuel destined for use as heating oil" will not include taxable fuel to be sold by the purchaser of the fuel to a third party for resale by such third party as heating oil. Thus, for example, a registered purchaser, *A*, purchases taxable fuel for sale to a producer or heating oil retailer, *B*, who will then sell the fuel to a consumer, *C*, for *C's* use as heating oil. The purchase made by both *B* and *C* will be considered under the regulations to be a purchase of taxable fuel destined for use as heating oil, but *A's* purchase will not. This is because *A* did not purchase the fuel for use by *A* or by *A's* purchaser, *B*, as heating oil. A person who does not qualify as a producer but who purchases taxable fuel for sale as heating oil must apply for registry as a heating oil retailer under the rules described in section IV(C) of this notice.

In addition, the regulations will provide that the application must include a statement setting forth in detail—

(a) A description of the equipment and facilities, if any, maintained for the production of diesel fuel,

(b) A description of the equipment and methods actually employed in the production of diesel fuel,

(c) The ingredients or materials utilized,

(d) The percentage that the sales, if any, of diesel fuel or diesel fuel in an alcohol mixture produced by the applicant, is expected to bear to total sales of diesel fuel or diesel fuel in an alcohol mixture by the applicant,

(e) The percentage that the total sales of heating oil, if any, is expected to bear to total sales of heating oil, diesel fuel, and diesel fuel in an alcohol mixture by the applicant,

(f) A description of any storage facilities used,

(g) A description of any equipment or facilities used for the transfer of diesel fuel and/or heating oil, if any,

(h) In the case of a wholesale distributor, the percentage that the bulk sales of diesel fuel to persons other than producers, if any, is expected to bear to total sales of diesel fuel,

(i) The names and addresses of all persons, if any, that will be used by the applicant as agents or brokers in the selling of diesel fuel and/or heating oil, if any, and

(j) The name and address of any person for whom diesel fuel will be purchased or imported by the applicant (*i.e.*, the beneficial owner).

(3) *Aviation Fuel*

The regulations will provide that a Certificate of Registry (Form 637A) issued pursuant to Chapter 31 of the Internal Revenue Code to a person who qualifies as an importer or producer (as defined in section 4092(b)) will apply until further notice to the tax imposed on aviation fuel under section 4091. Thus, an importer or producer of aviation fuel already registered on Form 637A may use such Certificate to make tax-free sales or purchases of aviation fuel under section 4091 until further notice. Until such notice, an importer or producer of aviation fuel holding a valid Certificate of Registry for tax-free sales and purchases of fuel used in an aircraft as of the date of this notice need not reapply for registry with respect to the tax imposed on aviation fuel under section 4091.

The regulations will require that an importer or producer of aviation fuel not holding a valid Certificate of Registry as of the date of this notice must register with respect to tax-free sales and purchases of aviation fuel under section 4091 on or after May 1, 1988, using Form 637A, in accordance with the instructions and applicable regulations, as modified in this notice. Section (c) of the instructions on Form 637A under "Who May Register" and all sections under "Exceptions to the Requirements for Registration" are no longer valid with respect to aviation fuel taxable under section 4091.

The regulations will provide that an application must include a statement as to whether the applicant is an importer, refiner, compounder, blender, wholesale distributor, or dealer selling fuel exclusively to producers. Each applicable designation on the form should be checked. If the form does not have a check box which applies to the applicant, check and complete the box, "Other (specify)". The application must specify "AVIATION FUEL" as the type of fuel bought or sold. In addition, the application must include a statement setting forth in detail—

(a) A description of the equipment and facilities, if any, maintained for the production of aviation fuel,

(b) A description of the equipment and methods actually employed in the production of aviation fuel,

(c) The ingredients or materials utilized,

(d) The percentage that the sales (if any) of aviation fuel or aviation fuel in an alcohol mixture produced by the applicant, is expected to bear to total sales of aviation fuel or aviation fuel in an alcohol mixture by the applicant,

(e) A description of any storage facilities used,

(f) A description of any equipment or facilities used for the transfer of any aviation fuel,

(g) The percentage that the bulk sales of aviation fuel is expected to bear to total sales of aviation fuel,

(h) The names and addresses of all persons, if any, that will be used by the applicant as agents or brokers in the selling of aviation fuel, and

(i) The name and address of any person for whom aviation fuel will be purchased or imported by the applicant (*i.e.*, the beneficial owner).

C. *Heating Oil Retailers*

(1) *Definitions*

(a) *Heating oil retailer*. The regulations will define the term "heating oil retailer" as a person other than a producer or importer who purchases taxable fuel for resale as fuel destined for use as heating oil. See section V of this notice regarding bonding requirements relating to heating oil retailers.

(b) *Fuel destined for use as heating oil.* The term "fuel destined for use as heating oil" will be defined in the regulations as taxable fuel that is intended to be used to provide heat, provided that the fuel is—

(i) purchased for use by the purchaser to provide heat, or

(ii) purchased by a registered importer, producer, or heating oil retailer for sale to a third party for use by such third party to provide heat.

Thus, for example, the term "fuel destined for use as heating oil" will include fuel to be used by the purchaser to heat a residence or commercial building. Another example of fuel destined for use as heating oil is fuel to be used by the purchaser to heat a boiler that produces steam to run a steam turbine. Taxable fuel destined for use as heating oil will sometimes be referred to as "heating oil".

However, as defined above, the term "fuel destined for use as heating oil" will not include taxable fuel to be sold by the purchaser of the fuel to a third party for resale by such third party as heating oil. Thus, for example, if *A* purchases taxable fuel for sale to *B*, who intends to use the fuel to heat *B's* building, then, assuming *A* is registered as a heating oil retailer (or as a producer selling both diesel fuel and heating oil), both the sale of taxable fuel to *A* and the sale of taxable fuel to *B* will be considered to be sales of fuel destined for use as heating oil. Alternatively, if *A* is a producer who purchases taxable fuel for sale to *B*, who intends to resell the fuel to *C*, the sale of taxable fuel to *A* is not a sale of fuel destined for use as heating oil, regardless of *C's* use of the fuel. However, the sale from *A* to *B* would be a sale of fuel destined for use as heating oil under the rule above if *C* intends to use the fuel purchased from *B* to heat *C's* building.

(2) *Making the application*

The regulations will require that an applicant qualify as a heating oil retailer in order to register to purchase or sell taxable fuel tax-free as a heating oil retailer. The regulations will provide that application for registry must be made on Form 637, "Registration for Tax-Free Transactions Under Chapters 31, 32, and 38 of the Internal Revenue Code". See section III(B)(2) of this notice regarding registration requirements relating to sales and purchases of taxable fuel destined for use as heating oil on or after October 1, 1988, and procedures to be used until that time. See section IV(B) of this notice for provisions relating to a producer or importer selling both diesel fuel and heating oil.

The application will be required to include a statement that the applicant is a "HEATING OIL RETAILER" purchasing "HEATING OIL". The form does not have a check box which applies to the applicant. The required information must be supplied under "Other (specify)". In addition, the application must include a statement setting forth in detail—

(a) That all taxable fuel certified by the applicant as fuel destined for use as heating oil is purchased for sale to the applicant's customers for use by such customers as heating oil,

(b) A description of any storage facilities used,

(c) A description of any equipment or facilities used for the transfer of heating oil, if any, and

(d) The names and addresses of all persons, if any, that will be used by the applicant as agents or brokers in the selling of heating oil.

(3) *Additional requirements*

The regulations will further provide that a registered heating oil retailer may purchase fuel destined for use as heating oil tax-free from a registered importer or producer provided that—

(a) The heating oil retailer intends to sell all the fuel so purchased for use by its customer(s) as heating oil,

(b) The seller obtains from the purchaser and keeps on file a certification described in section III(B)(2)(b)(i)(*B*) of this notice, and

(c) The importer or producer in the normal course of business maintains on file copies of invoices of sales of taxable fuel showing the name of the purchaser, the purchaser's Certificate of Registry number, the date of sale, and the type and volume of product sold.

The regulations will provide that a District Director has the authority to deny to any applicant the right to buy taxable fuel tax-free as fuel destined for use as heating oil if the District Director determines that the District Director cannot verify the accuracy of, or compliance with the terms of, any certification provided by such person.

In addition, the regulations will provide that a District Director may revoke a person's registry as a heating oil retailer at any time in a case where fuel is purchased tax-free as fuel destined for use as heating oil and—

(i) At the time of purchase, such retailer does not intend to sell the fuel purchased for use as heating oil,

(ii) If at the time the retailer sells fuel that was purchased as heating oil, such retailer has reason to believe that the fuel will be used other than as heating oil, or

(iii) The District Director deems it necessary in order to ensure the collection of the tax imposed by section 4091. The regulations will provide that a heating oil retailer has reason to believe that fuel will be used for a purpose other than as heating oil if, for example, the retailer knows that the purchaser of the fuel from the retailer does not have the equipment or facilities to use the fuel as heating oil, or the retailer knows that the use of the fuel as heating oil is inconsistent with the type of business the purchaser operates. An example of an inconsistent use indicating a reason to believe that the fuel will be used other than as heating oil is one in which a heating oil retailer, while aware that a purchaser's sole business is the operation of a fleet of diesel-powered highway vehicles, nevertheless sells large quantities of taxable fuel to such purchaser for use as heating oil. However, any such revocation by the District Director will be prospective only and shall not result in the imposition of tax on a registered importer or producer with respect to any previous sale of taxable fuel to such heating oil retailer if the importer or producer in good faith accepted a proper certification from the heating oil retailer that the fuel was intended for sale as heating oil.

D. *Purchaser of Fuel for Use in a Diesel-Powered Train*

(1) *Making the application*

The regulations will require that a purchaser of fuel for use in a diesel-powered train register using Form 637, "Registration for Tax-Free Transactions Under Chapters 31, 32, and 38 of the Internal Revenue Code". See section III(B)(2) of this notice regarding registration requirements relating to sales and purchases of diesel fuel for use in a diesel-powered train on or after October 1, 1988, and procedures to be used until that time. The regulations will define the term "train" to include a locomotive, work train, switching engine, track maintenance machine, or other equipment incident to train operations, so long as such equipment or machinery rides on rails. The term "train" will not include any equipment or machinery that does not ride on rails.

The applicant's type of business (*e.g.*, "RAILROAD") is to be entered under "Other (specify)". The application will be required to include a statement that the applicant is buying "DIESEL FUEL" for use in a diesel-powered train, and that the applicant qualifies for this exemption as an "OPERATOR OF A DIESEL-POWERED TRAIN" under "Other (specify)". In addition, the application must include a statement setting forth in detail—

(a) The amount of taxable fuel expected to be used in a diesel-powered train,

(b) The percentage that the usage, if any, of diesel fuel or diesel fuel in an alcohol mixture by the applicant in a diesel-powered train, is expected to bear to total usage of diesel fuel or diesel fuel in an alcohol mixture by the applicant,

(c) A description of any storage facilities used, and

(d) A description of any equipment or facilities used for the transfer of diesel fuel, if any.

(2) *Additional requirements*

The regulations will further provide that a registered purchaser of diesel fuel for use in a diesel-powered train may purchase fuel tax-free for such use from a registered importer or producer provided that—

(a) The purchaser intends to use all the fuel so purchased as fuel for a diesel-powered train,

(b) The seller obtains from the purchaser and keeps on file a certification described in section III(B)(2)(b)(i)(*B*) of this notice, and

(c) The importer or producer in the normal course of business maintains on file copies of invoices of sales of taxable fuel showing the name of the purchaser, the purchaser's Certificate of Registry number, the date of sale, and the type and volume of product sold.

In addition, the regulations will provide that a District Director may revoke a person's registry as a purchaser of fuel for use in a diesel-powered train at any time if, at the time of purchase, such purchaser does not intend to use the fuel that was purchased tax-free as fuel for a diesel-powered train, or if the District Director deems it necessary in order to ensure the collection of the tax imposed by section 4091. However, any such revocation by the District Director will be prospective only and shall not result in the imposition of tax on a registered importer or producer with respect to any previous sale of taxable fuel to such purchaser if the importer or producer in good faith believed that the fuel was to be used as fuel for a diesel-powered train.

E. *Purchaser of Fuel for Use in an Aircraft Not in Noncommercial Aviation*

(1) *Making the application*

The regulations will require that a purchaser of aviation fuel for use in an aircraft not in noncommercial aviation make application for registry with respect to aviation fuel on Form 637A, "Registration for Tax-Free Sales and Purchases of Fuel Used in Aircraft Under Chapter 31 of the Internal Revenue Code" in order to purchase fuel for such use tax-free. The regulations will further provide that a valid Certificate of Registry (Form 637A) issued to a person purchasing aviation fuel for use in an aircraft not in noncommercial aviation will apply to the tax imposed on aviation fuel under section 4091 until further notice. Until such notice, a person holding a valid Certificate of Registry for tax-free purchases of fuel for use in an aircraft not in noncommercial aviation as of the date of this notice need not reapply for registry with respect to the tax imposed on aviation fuel under section 4091. The regulations will also provide that the rules described in section III(B)(2)(b) of this notice will apply to such a registered person for sales of aviation fuel on or after April 1, 1988. See also paragraph (2) of this section, below.

A person not holding a valid Certificate of Registry for tax-free purchases of fuel for use in an aircraft not in noncommercial aviation as of the date of this notice must apply for registry with respect to tax-free sales and purchases of aviation fuel under section 4091 on Form 637A in accordance with the instructions and applicable regulations, as modified in this notice. See section III(B)(2) of this notice regarding registration requirements relating to sales and purchases of aviation fuel for use in an aircraft not in noncommercial aviation on or after October 1, 1988, and procedures to be used until that time.

The application must include a statement that the applicant is a commercial airline or other person purchasing "AVIATION FUEL" for use in an aircraft not in noncommercial aviation. In addition, the application must include a statement setting forth in detail the percentage that the usage, if any, if aviation fuel or aviation fuel in an alcohol mixture, in an aircraft not in noncommercial aviation is expected to bear to total usage of aviation fuel or aviation fuel in an alcohol mixture by the applicant.

(2) *Additional requirements*

The regulations will further provide that a registered purchaser of aviation fuel for use not in noncommercial aviation may purchase fuel for such use from a registered importer or producer provided that—

(a) The purchaser intends to use all the fuel so purchased as fuel for an aircraft not in noncommercial aviation,

(b) The seller obtains from the purchaser and keeps on file a certification described in section III(B)(2)(b)(i)(*B*) of this notice, and

(c) The importer or producer in the normal course of business maintains on file copies of invoices of sales of taxable fuel showing the name of the purchaser, the purchaser's Certificate of Registry number, the date of sale, and the type and volume of product sold.

In addition, the regulations will provide that a District Director may revoke a person's registry as a purchaser of fuel for use in an aircraft not in noncommercial aviation, at any time if, at the time of purchase, such purchaser does not intend to use the fuel that was purchased tax-free as fuel in an aircraft not in noncommercial aviation, or if the District Director deems it necessary in order to ensure the collection of the tax imposed by section 4091. However, any such revocation by the District Director will be prospective only and shall not result in the imposition of tax on a registered importer or producer with respect to any previous sale of taxable fuel to such purchaser if the importer or producer in good faith believed that the fuel was to be used as fuel for an aircraft not in noncommercial aviation.

F. *Purchaser of Fuel for Use Other Than as a Motor Fuel*

(1) *Definitions*

(a) *In general.* For purposes of this exemption, the regulations will provide that use of taxable fuel "other than as a motor fuel" shall include use as a chemical feedstock, solvent, cleaner, or for explosives. Use other than as a motor fuel will not include use of taxable fuel in any motor, engine, machine, generator, self-propelled machinery, or vessel or boat. See, however, section IV(C)(1)(b) of this notice regarding taxable fuel used to heat a boiler.

(b) *Request for comments.* Persons who use taxable fuel for a non-motor fuel use not listed above, and who purchase and store such fuel in bulk quantities are requested to write to the Internal Revenue Service describing such use. This information will be used to develop regulations relating to the exemption for taxable fuel sold for use other than as a motor fuel. Address comments to Ms. Lauren G. Shaw of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC 20224 (Attention CC:LR:4).

(2) *Making the application*

The regulations will provide that application for registry must be made on Form 637, "Registration for Tax-Free Transactions Under Chapters 31, 32, and 38 of the Internal Revenue Code". See section III(B)(2) of this notice, describing that the regulations will require a purchaser of taxable fuel for use other than as a motor fuel to be registered in order to make tax-free purchases of diesel fuel for this use on or after October 1, 1988, and the procedures to be followed for tax-free sales until that time. The application must include a statement that the applicant is a purchaser of taxable fuel "FOR USE OTHER THAN AS A MOTOR FUEL." In addition, the application for registry will be required to include a statement setting forth in detail—

(a) A description of the intended use of the fuel other than as a motor fuel,

(b) The amount of taxable fuel expected to be used other than as a motor fuel,

(c) The ingredients or materials utilized,

(d) The percentage that the usage, if any, of diesel fuel or diesel fuel in an alcohol mixture by the applicant other than as a motor fuel, is expected to bear to total usage of diesel fuel or diesel fuel in an alcohol mixture by the applicant,

(e) A description of any storage facilities used, and

(f) A description of any equipment or facilities used for the transfer of diesel fuel and/or heating oil, if any.

(3) *Additional requirements*

The regulations will further provide that a registered purchaser of taxable fuel for use other than as a motor fuel may purchase fuel for such use from a registered importer or producer provided that—

(a) The purchaser intends to use all the fuel so purchased other than as a motor fuel,

(b) The seller obtains from the purchaser and keeps on file a certification described in section III(B)(2)(b)(i)(*B*) of this notice, and

(c) The importer or producer in the normal course of business maintains on file copies of invoices of sales of taxable fuel showing the name of the purchaser, the purchaser's Certificate of Registry number, the date of sale, and the type and volume of product sold.

In addition, the regulations will provide that a District Director may revoke a person's registry as a purchaser of fuel for use other than as a motor fuel at any time if, at the time of purchase, such purchaser does not intend to use the fuel that was purchased tax-free in a use other than as a motor fuel, or if the District Director deems it necessary in order to ensure the collection of the tax imposed by section 4091. However, any such revocation by the District Director will be prospective only and shall not result in the imposition of tax on a registered importer or producer with respect to any previous sale of taxable fuel to such purchaser if the importer or producer in good faith believed that the fuel was to be used other than as a motor fuel.

G. *State or Local Government*

(1) *In general*

The regulations will provide that, until further notice, a state or local government will not be required to register for tax-free sales of taxable fuel under section 4093(c) if it buys its fuel from a registered importer or producer before the section 4091 tax has been imposed. However, the regulations will provide that if a state or local government purchases fuel on which the section 4091 tax has already been imposed and the price paid by the state or local government includes the section 4091 tax, the state or local government may file a claim for a credit or refund. This rule is explained in more detail at sections I(D)(4)(a) and II(A) of this notice.

The regulations will further provide that on or after April 1, 1988, a state or local government may purchase taxable fuel tax-free from a registered importer or producer provided that—

(a) The importer or producer in the normal course of its business maintains on file copies of invoices of sales of taxable fuel showing the name of the purchaser, the date of purchase, and the type and volume of product purchased,

(b) The importer or producer obtains from the state or local government and keeps on file a certification, in the form provided below and signed under penalties of perjury by a person having authority to bind the state or local government, that all fuel purchased is purchased for the exclusive use of the state or local government,

(c) The Federal employer identification number of the estate or local government is attached to, or appears on, the face of the invoice for the sale, and

(d) The sales invoice contains a written statement clearly indicating that the entire quantity of the fuel is purchased for the exclusive use of a state or local government.

The regulations will give the District Director authority to deny to any state or local government the right to buy taxable fuel tax-free if the District Director determines that the District Director cannot verify the accuracy of, or compliance with the terms of, any certification provided by such state or local government. However, any such action by the District Director will be prospective only and shall not result in the imposition of tax on a registered importer or producer with respect to any previous sale of taxable fuel to such state or local government.

The regulations will provide that one certification may be used by all agencies, boards, and commissions of a state that are authorized by the state to make purchases for the exclusive use of the state, but that such certification may not be used by any political subdivision of that state, such as a county or municipality. Each such political subdivision will be required to supply a separate certification relating to fuel purchased for its exclusive use.

(2) *Form of certification*

The regulations will provide that the certification may cover sales of taxable fuel to the state or local government for a period not to exceed 12 calendar quarters, and shall take the following form:

"The undersigned purchaser ("Purchaser") hereby certifies that (a) Purchaser is a state or local government buying taxable fuel for its exclusive use, and that (b) the taxable fuel to which this certification relates is purchased for the exclusive use of Purchaser.

"If this taxable fuel is used by Purchaser for a purpose other than as stated above, then Purchaser understands that Purchaser may be subject to tax and may be subject to penalties if Purchaser does not satisfy applicable registration requirements before incurring any liability for tax resulting from such use. Purchaser will be prepared to establish by satisfactory evidence the purpose for which Purchaser used the product purchased under this certification.

"Purchaser understands that any fraudulent use of this certification to purchase any taxable fuel free of tax will subject Purchaser to penalties of perjury, which may include fine and imprisonment."

E.I.N.: ______________________

Address: ______________________

____

____

by ______________________

Title ______________________

V. BOND REQUIREMENTS

A. *In General*

The regulations will provide that any person required to register to make tax-free purchases under section 4093 may be required to post a bond with respect to the tax imposed by section 4091. Generally, under the regulations, no bond will be required with respect to the tax imposed by section 4091 if a person has an acceptable filing, deposit, and payment history in all areas of Federal taxation, as described in paragraph (B) of this section. In no case will the regulations require a bond of a state or local government purchasing taxable fuel for its exclusive use, or a heating oil retailer purchasing only fuel destined for use as heating oil as that term is defined under section IV(C)(1)(b) of this notice. However, the regulations will provide that if a heating oil retailer purchases both fuel destined for use as heating oil and taxable fuel not destined for use as heating oil, the heating oil retailer may be required to post a bond with respect to taxable fuel purchased other than as fuel destined for use as heating oil. See section IV(C) of this notice for additional requirements relating to heating oil retailers.

B. *Standards for Requiring a Bond*

The regulations will provide that, to determine if an applicant has an acceptable tax compliance history, the District Director will examine whether the applicant has a satisfactory filing, deposit, and payment history. The regulations will direct the District Director to examine the applicant's filing, deposit, and payment history in all areas of Federal taxation, including income, employment, and excise taxes for either the preceding 8 quarters (for taxes due on a quarterly basis) or the preceding 2 years (for taxes due on an annual basis) to determine if the applicant has filed tax returns and made deposits and payments of tax in a timely manner. The regulations will provide that, if the District Director is not satisfied with the filing, deposit, and payment history of the applicant, or no such history exists (*e.g.*, in the case of a newly created business), a bond will be required, but that under extenuating circumstances (*e.g.*, bankruptcy of the applicant), the District Director may waive the bond requirement and accept an alternative form of security. The regulations will provide that the bond shall be filed with a Form 928, modified to apply to the tax imposed under section 4091.

C. *Amount of Bond*

The regulations will provide that, if a bond is required, the amount of the bond will be the lesser of (1) $500,000 or (2) the amount of tax that would be imposed under section 4091 on the expected volume of taxable fuel that will be used or sold by the applicant during an average 1-month period other than fuel destined for use as heating oil (as determined by the District Director) as if all such use or sales are taxable. This requirement may result in a bond being required from some persons that do not expect to incur any tax liability under section 4091, such as, for example, a newly established purchaser of fuel for use in a diesel-powered train or a producer that sells to other producers. The regulations will also provide that a strengthening or superseding bond may be required if, for any month, the actual volume of taxable fuel sold is greater than the volume on which the existing bond is based.

D. *Acceptable Issuer*

The regulations will provide that, if a bond is required, the surety on the bond must be a company approved for inclusion on the Department of the Treasury Circular 570 as an acceptable surety or reinsurer on Federal bonds. Under the regulations, any other company or individual will not be acceptable as a surety for purposes of a bond required under sections 4091 and 4101.

E. *Release of Bond*

The regulations will provide that a registrant that is required to give a bond may apply to the District Director for the release of the bond, based on a showing of satisfactory filing, deposit, and payment history.

VI. FLOOR STOCKS TAX

A. *In General*

Section 10502(f) of the 1987 Act imposes a floor stocks tax on any taxable fuel held by a taxable person at the first moment of April 1, 1988, at the rate of tax which would be imposed if such fuel were sold on such date in a sale subject to tax under section 4091 of the Internal Revenue Code. The taxes imposed by section 10502(f) of the 1987 Act shall be paid before June 16, 1988.

Section 4091(b) provides that the Highway Trust Fund financing rate is 15 cents per gallon, the Airport and Airway Trust Fund financing rate is 14 cents per gallon, and the L.U.S.T. tax rate is 0.1 cent per gallon. Section 4091(c) provides that the Highway Trust Fund financing rate for diesel fuel for use in producing a diesel fuel mixture is 10 cents per gallon if at least 10 percent of such mixture consists of alcohol. The Highway Trust Fund financing rate for such a mixture of diesel fuel and alcohol is 9 cents a gallon if the diesel fuel in such mixture was not taxed at the 10-cent per gallon rate. Section 4091(d) provides that the Airport and Airway Trust Fund financing rate shall not apply to the sale of any mixture of aviation fuel if at least 10 percent of such mixture consists of alcohol or to the sale of aviation fuel for use in producing such a mixture. Thus, the effective rates of tax are as follows:

Type of fuel	Cents per gallon
Diesel fuel	15.1
Diesel fuel for trains	0.1
Diesel fuel for blending with alcohol	10.11
Diesel fuel in alcohol mixture	9.1
Aviation fuel (commercial use)	0.1
Aviation fuel (noncommercial use)	14.1

B. *Definitions*

For purposes of the floor stocks tax, the regulations will provide that the term "taxable fuel" means any taxable fuel (as defined in section 4092 of the Internal Revenue Code) on which no tax has been imposed under section 4041 of such Code. Such term does not include fuel held exclusively for any use which is a nontaxable use as defined in section 6427(l) of such Code. The term "taxable person" will be defined to mean any person other than a producer (as defined in section 4092 of such Code) or importer of taxable fuel. Fuel will be treated as held by a person if title thereto has passed to such person whether or not delivery to such person has been made. For example, a taxable person may be a retailer of diesel fuel, a construction company, or a farmer holding diesel fuel in storage. If such person holds such fuel exclusively for a nontaxable use, then the fuel will not be considered to be taxable fuel for purposes of the floor stocks tax. However, if such person holds such fuel for a taxable use, or for both taxable and nontaxable uses, the regulations will provide that the fuel is taxable fuel for purposes of the floor stocks tax.

For purposes of the floor stocks tax imposed by section 10502(f), only the L.U.S.T. tax shall apply with respect to diesel fuel held exclusively for use as a fuel in a diesel-powered train and aviation fuel held exclusively for use as a fuel in an aircraft not in noncommercial aviation.

C. *Inventory*

The regulations will require every taxable person liable for the floor stocks tax on taxable fuel to prepare an inventory of taxable fuel held at the first moment of April 1, 1988. Taxable persons holding taxable fuel subject to the tax at more than one location will be required to prepare a separate inventory, in duplicate, for each such location. One copy of the separate inventory is to be retained at the location and one copy is to be kept at the principal place of business of the taxable person. Each inventory is to show the name of the taxable person, the location of the particular premises for which the inventory is made, the address shown on the taxable person's tax return, and the total number of gallons of taxable fuel held at the particular location that are subject to the floor stocks tax on taxable fuel. The regulations will provide that the inventory is not to be filed with the return but is to be retained by the taxpayer.

D. *Special Rule for Determining Amount of Taxable Fuel Held in Inventory*

As explained above, taxable persons are required to make an inventory of all taxable fuel held on April 1, 1988, and keep records of that inventory. The regulations will provide that, in determining the amount of taxable fuel subject to the floor stocks tax, a taxable person may exclude the amount of taxable fuel in dead storage. "Dead storage" will be defined as the amount of taxable fuel that will not be pumped out of a storage tank because the taxable fuel is below the mouth of the draw pipe. For this purpose, a taxable person will be permitted to assume that the amount of taxable fuel in dead storage is 200 gallons for a tank with a capacity of less than 10,000 gallons and 400 gallons for a tank with a capacity of 10,000 gallons or more. Alternatively, a taxable person will be permitted to compute the amount of taxable fuel in dead storage by using the manufacturer's conversion table for the tank and the number of inches between the bottom of the tank and the mouth of the draw pipe. If the taxable person uses the conversion table method to compute the amount of taxable fuel in dead storage, the distance between the bottom of the tank and the mouth of the draw pipe is to be assumed to be 6 inches, unless the taxable person establishes otherwise.

E. *Requirements With Respect to Return*

(1) *Form*

The regulations will require every person liable for the floor stocks tax on taxable fuel to make a return of the tax on Form 720.

(2) *Time and place for filing return*

The return reflecting the floor stocks tax is to be filed with the Service Center indicated by the instructions for the Form 720. The regulations will provide that in the case of a taxable person not otherwise required to file Form 720, the return must be filed before June 16, 1988, and must be marked "FINAL". If liability is subsequently incurred by such taxable person during the quarter ending June 30, 1988, so that a second Form 720 is required to be filed for that quarter, the taxable person must mark the second Form 720 "AMENDED". In the case of all other taxable persons, the regulations will require that the return reflecting the floor stocks tax be filed on or before the date prescribed by the instructions for the Form 720 for the quarter ending June 30, 1988. For provisions relating to timely filing and paying, see sections 7502 and 7503. For provisions relating to additions to the tax in case of failure to file a return within the prescribed time, see section 6651 and §301.6651.

(3) *Time and place for paying tax*

The regulations will provide that the tax is due and payable without assessment or notice, before June 16, 1988. If a taxable person is not required to make a deposit of any tax reported on Form 720 using a Federal Tax Deposit Coupon for the quarter ending June 30, 1988, the taxable person is to pay the tax by check or money order. Such check or money order must reflect the taxable person's taxpayer identification number, and "Form 720 Second Quarter 1988, Floor Stocks Tax on [TYPE OF FUEL] and the IRS number of each fuel. The IRS numbers for each fuel are as follows:

Type of fuel	IRS Number
Diesel fuel	85
Diesel fuel for trains	71
Diesel fuel for blending with alcohol	86
Diesel fuel in alcohol mixture	86
Aviation fuel (commercial use)	77
Aviation fuel (noncommercial use)	87

The check or money order must be sent, together with the Form 720, to the Service Center indicated by the instructions for the Form 720. All other taxable persons shall pay the tax by making a deposit of the tax, together with a Federal Tax Deposit Coupon before June 16, 1988, at an authorized depository or the Federal Reserve Bank serving the taxable person's area. For provisions relating to interest on underpayments, additions to tax, and penalties, see the applicable sections of 26 C.F.R. Part 301 (Regulations on Procedure and Administration).

(4) *Credit or refund*

The regulations will provide that any person who has paid a floor stocks tax on taxable fuel may be entitled, subject to the provisions of sections 6416 and 6427, to a credit or refund of the tax for any of the reasons specified in section 6416 or 6427. That is, in the case of the floor stocks tax, either the exempt user or the seller of the fuel to the exempt user may claim the refund or credit. Under the regulations, credit or refund may be claimed for any of the purposes specified relating to—

(a) Export or shipment to a possession of the United States;

(b) Supplies for vessels or aircraft,

(c) Exclusive use of a state or local government,

(d) Exclusive use of a nonprofit educational organization,

(e) Use of taxable fuel in the production of special fuels,

(f) Off-highway business use,

(g) Intercity, local, or school buses,

(h) Use on a farm for farming purposes,

(i) Use by certain aircraft museums,

(j) Certain helicopter uses, or

(k) Certain taxicab uses.

Claims for refund under section 10502(f) of the Revenue Act are to be filed on Form 843, "Claim". Subject to the provisions of sections 6416 and 6427, any person entitled to claim a refund of tax may, in lieu of claiming a refund, claim a credit for the tax against taxes imposed under Subtitle A or Chapter 32 of Subtitle F of the Internal Revenue Code on any subsequent return. A taxpayer should attach to the return a statement or a Form 4136, "Computation of Credit for Federal Tax on Gasoline and Special Fuels", if applicable, to show the computations. See also section VIII of this notice regarding credit and refund procedures.

(5) *Records*

The regulations will require every person liable for the floor stocks tax on taxable fuel to maintain—

(a) Records of the separate inventories required by section VI(C) of this notice,

(b) A duplicate copy of the return, together with other relevant papers and material, and

(c) A complete and detailed record with respect to any claim of refund or credit of the tax.

All records required by this paragraph are to be kept at the principal place of business of the person required to maintain the records. The records are at all times to be available for inspection by internal revenue agents and officers. Records required by paragraph (5)(a) and (b) of this section are to be maintained for a period of at least three years after the date the tax becomes due or the date the tax is paid, whichever is later. Records required by paragraph (5)(c) of this section (including any record required by paragraph (5)(a) or (b) that relates to a claim) are to be maintained for a period of at least three years after the last day prescribed for the filing of the claim for credit or payment.

VII. REPORTING REQUIREMENTS

A. *Filing Requirements*

The regulations will provide that liability for tax imposed under section 4091 must be reported on Form 720 (Quarterly Federal Excise Tax Return in accordance with the instructions for Form 720 and the applicable regulations.

B. *Recordkeeping Requirements*

The regulations will require each person who is registered or required to register under section 4101 or 4093, and each state or local government purchasing taxable fuel tax-free, to maintain adequate records of all taxable fuel it purchases, sells, or uses. For each purchase, sale, or use of taxable fuel, the regulations will require that the record include: (1) the volume of taxable fuel, (2) the type(s) of taxable fuel, (3) the date of the transaction, (4) the name and status of each person involved (*e.g.*, *X* Corporation as seller and *A* Proprietor as purchaser), and (5) whether the sale or use is taxable. Any person who claims a credit or refund of tax imposed under section 4091 is to maintain adequate records to support the credit or refund. All records required by this paragraph are to be kept at the principal place of business of the person required to maintain the records. The records are at all times to be available for inspection by internal revenue agents and officers. Records required by this section are to be maintained for a period of at least three years after either (1) the date the tax becomes due or is paid (whichever is later), or (2) the last date prescribed for the filing of the claim for credit or payment, as applicable.

Section 4093(d) gives the Secretary authority to require information reporting as the Secretary deems necessary to carry out the subpart. Later regulations may require additional recordkeeping and information reporting.

VIII. CREDIT AND REFUND PROCEDURES

Exempt users should use Form 4136, "Computation of Credit for Federal Tax on Gasoline and Special Fuels", to claim a credit against Federal income tax liability, or Form 843, "Claim", to request a refund of taxes paid, with respect to taxable fuel used for a nontaxable purpose. For more information regarding credits or refunds, see I.R.S. Publication 378, "Fuel Tax Credits". See also Publication 510, "Excise Taxes for 1988" for general information regarding Federal excise taxes. Also available are Publication 225, "Farmer's Tax Guide", and Publication 595, "Tax Guide for Commercial Fishermen". Forms and publications can be ordered from the Forms Distribution Center for your state at the address below or by calling 1-800-424-FORM. Please note, however, that these forms and publications were last revised before the enactment of the Revenue Act of 1987, and do not yet reflect changes made to the Internal Revenue Code by that law. They can be used for general information, but should be read in conjunction with the revised Internal Revenue Code.

If you are located in:	*Send to:*
Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington, Wyoming	Forms Distribution Center P.O. Box 12626 Fresno, CA 93778
Alabama, Arkansas, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Michigan, Minnesota, Mississippi, Missouri, Nebraska, North Dakota, Ohio, Oklahoma, Puerto Rico, South Dakota, Tennessee, Texas, Wisconsin	Forms Distribution Center P.O. Box 9903 Bloomington, IL 61799
Connecticut, Delaware, District of Columbia, Florida, Georgia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, West Virginia	Forms Distribution Center P.O. Box 25866 Richmond, VA 23260
Virgin Islands	V.I. Bureau of Internal Revenue P.O. Box 3186 St. Thomas, VI 00801
Foreign addresses	Richmond, VA or Fresno, CA

IX. ADMINISTRATIVE PRONOUNCEMENT

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Passive Foreign Investment Company Provisions Section 1295: Election to be a Qualified Electing Fund

Notice 88-31

Section 1295 Elections by Shareholders

The Internal Revenue Service will amend the temporary regulations concerning passive foreign investment companies and the qualified electing fund election under section 1295 that were published in the *Federal Register*, 53 Fed. Reg. 6770 (March 2, 1988)—(T.D. 8178) [page 313, this Bulletin]. The election must be made on or before March 14, 1988, for taxable year ending on or before December 31, 1987. The amended regulations will provide, however, that the qualified electing fund (QEF) election may be made by any shareholder of a passive foreign investment company (PFIC) that is a U.S. person provided the election is ratified by the PFIC no later than December 15, 1988.

Section 1.1295-1T(b)(1) will be amended to permit the QEF election for taxable years ending before October 1, 1988, to be made on behalf of the PFIC by any shareholder of a PFIC that is a U.S. person (including any U.S. person that is a shareholder of a PFIC by application of the attribution rules of section 1297(a) of the Code). The election statement filed by a U.S. person who is a shareholder of the PFIC must have the heading, "Shareholder Section 1295 Election—Subject to Corporate Ratification," and contain the information required by §1.1295-1T(b)(2)(ii)(A), (B), and (C), to the extent known by the shareholder. The shareholder making the election also must provide his/her/its name, address, and taxpayer identification number, represent that he/she/it was a shareholder of the PFIC during the taxable year of the PFIC for which the election is made, and sign the election statement, under penalties of perjury, stating that the information and representation provided are true, correct and complete to the best of the shareholder's knowledge and belief. An election made by a shareholder must be filed with the Philadelphia Service Center, P.O. Box 21086, Philadelphia, PA 19114, before the 15th day of the third month following the taxable year of the PFIC for which the election is made. For taxable year ended on or before December 31, 1987, the election must be filed on or before March 14, 1988.

Section 1.1295-1T(b)(1) will be amended to provide that an election made by a shareholder will be valid provided the PFIC, by December 15, 1988, reports to the Internal Revenue Service, at the Philadelphia address provided above, that it formally ratified the election made by the shareholder. The PFIC also must satisfy the other election requirements set forth in §1.1295-1T(b) by December 15, 1988.

Section 1.1295-1T(b)(1)(iii) of the temporary regulations also will be amended to apply to elections that must be filed before November 15, 1988. If a PFIC or its shareholder files a statement containing the information required in §1.1295-1T(b)(2)(ii)(A), (B), and (C) before the 15th day of the third month following the taxable year of the PFIC for which the election is being made, the PFIC will have until December 15, 1988, to satisfy the other election requirements provided in §1.1295-1T(b), including sending the shareholder notification and request for certification.

Section 1.1295-1T(b)(6)(i), which requires annual reporting by the PFIC to the Internal Revenue Service, also will be amended. A PFIC whose election was made for its taxable year ending before July 1, 1988, will have until March 15, 1989, to satisfy the annual reporting requirement of §1.1295-1T(b)(6).

Section 1.1294-1T(c()2) will be amended to provide that a shareholder who wishes to make the election under section 1294 to extend the time for payment of tax on its share of the undistributed earnings of the PFIC, but is required under §1.1294-1T(c)(1) to make the election before March 15, 1989, will have until March 15, 1989, to amend its tax return and make the election under section 1294.

Time for Mailing Elections under Section 1295

The Internal Revenue Service also will amend §1.1295-1T(b)(1)(i) to modify the date an election under section 1295 mailed outside the United States must be postmarked to be considered filed by March 14, 1988. Section 1.1295-1T(b)(1)(i) provides that a foreign corporation electing to be a qualified electing fund must file its election before the 15th day of the third month following the year for which the election is made. An election mailed outside the United States in the manner described in that paragraph must be postmarked at least 10 calendar days before the due date. The Internal Revenue Service will amend §1.1295-1T(b)(1)(i) to provide that an election under section 1295 that is due by March 14, 1988, and is mailed outside the United States will be timely filed if postmarked on or before March 14, 1988.

Effective Date

This document serves as an "administrative pronouncement" as that term is used in §1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure. *See* Rev. Rul. 87-138, 1987-2 C.B. 287. Taxpayers may rely on this notice until the amended regulations are published. The regulations will be effective for taxable year beginning after December 31, 1986.

Clarification of the Requirement to Furnish Tax Shelter Registration Numbers

Notice 88-32

This notice provides further clarification of the instructions for Form 8271, Investor Reporting of Tax Shelter Registration Number, in connection with certain acquisitions involving tax shelters required to be registered under section 6111 of the Internal Revenue Code. Section 6111 of the Code and section 1.6111-1T of the Income Tax Regulations require the registration of tax shelters. In addition, any person who transfers an interest in a tax shelter is required to furnish the tax shelter registration number to any transferee of such interest. This notice supplements the provisions of Announcement 85-33, I.R.B. 1985-9, 22, which clarified the instructions to Form 8271 to provide rules under section 6111 that are applicable to an investment by a partnership, an S corporation or a trust ("pass-through entities") in a tax shelter.

This notice clarifies the tax shelter reporting requirements under section 6111 of the Code in the case of the substantial acquisition by a pass-through entity of an interest in an investment that has been registered as a tax shelter. If

(i) a pass-through entity acquires at least a 50 percent interest (in profits and capital), during one taxable year of such pass-through entity, in an investment that is registered as a tax shelter (and in which the pass-through entity had not held an interest prior to that taxable year), and

(ii) the investment would not meet the definition of a tax shelter (within the meaning of section 6111(c)(1)(A) of the Code as to any investor) immediately following the acquisition if the investment had been offered for sale at that time (For example, this situation could occur if debt incurred to finance the investment were satisfied in connection with the acquisition, thereby reducing the tax shelter ratio for each investor to less than 2 to 1.), then the pass-through entity is not required under section 6111 to give a copy of Form 8271 to its partners, shareholders or beneficiaries (as the case may be) with respect to its interest in the investment. All other investors who hold or acquire (directly or indirectly) an interest in the tax shelter investment (i.e., investors other than those to whom a pass-through entity is not required to furnish a registration number under this notice) are required to prepare and include a Form 8271 for the investment with their Federal income tax returns and to furnish the number to any persons to whom they transfer an interest in the investment. In addition, the pass-through entity is required to prepare a Form 8271 and include Form 8271 with its Form 1065, 1120S, or 1041.

The Service is actively considering the application of the tax shelter number reporting requirements in the situation described above and other similar situations. The Service solicits comments on this matter from interested practitioners and taxpayers.

PROCEDURAL INFORMATION

This notice serves an an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Employee Plans—Distribution of Excess Amounts

Notice 88-33

This notice provides guidance with respect to the distribution of excess deferrals under section 402(g), excess contributions under section 401(k) excess aggregate contributions under section 401(m). In general, these excess amounts (with allocable income) must be returned within a short period of time after the end of the tax or plan year to avoid sanctions under the Internal Revenue Code of 1986. The notice advises plan sponsors of methods that will be considered reasonable for purposes of allocating gain or loss to excess amounts; provides a safe harbor method for computing the gain or loss allocable to the excess amount for the period between the end of the year and the date of distribution; and provides special rules for the treatment of certain losses allocable to excess amounts. Finally, the notice provides transitional relief with respect to the definition of highly compensated employees.

Background

Section 402(g) of the Code, as added by section 1105(a) of the Tax Reform Act of 1986 (TRA), Pub. L. 99-514, [1986-3 (Vol. 1) C.B. 334] places limitations on the amount of elective deferrals that employees may make to section 401(k) arrangements, section 403(b) arrangements, sections 408(k) salary reduction simplified employee pensions (SARSEPs), and section 501(c)(18) plans. In general, this limitation is $7,000 ($9,500 for 403(b) plans) for the 1987 taxable year. Amounts in excess of this limitation and income thereon are treated as income to the employee in 1987. If not distributed by April 15, 1988, such amounts are treated as employer contributions and may not be distributed until other distributions of employer contributions are permitted by the terms of the plan. Furthermore, such amounts will again be subject to taxation at the time of distribution.

Section 401(k)(3) of the Code, as amended by TRA, places limitations on the amount of elective contributions that employees may make to a cash or deferred arrangement. Section 401(m) of the Code, as added by TRA, imposes limitations on amounts of employee contributions and matching contributions that may be contributed to qualified plans under section 401(a) and annuity plans under section 403(a) and 403(b). In general, these limitations are determined by comparing the percentage of contributions made by highly compensated employees to those made by employees who are not highly compensated.

With respect to participants, an excess contribution or an excess aggregate contribution (plus income) distributed within 2 1/2 months after the end of the plan year is includible in the gross income of the participant on the earliest date any elective contribution by the employee during the plan year would have been received by the employee had the employee originally elected to receive the amounts in cash. If it is distributed after the 2 1/2 month period but before the close of the plan year following the plan year in which it was contributed, it is includible in the gross income of the participant in the taxable year in which it is distributed. With respect to a SARSEP, an excess contribution (plus allocable income) is includible in gross income in the year contributed, regardless of when it is distributed.

If the excess contribution or excess aggregate contribution is distributed after the 2 1/2 month period, the employer will be subject to a penalty tax equal to 10% of such excess amount under section 4979 of the Code. If the excess contribution or excess aggregate contribution is not distributed before the close of the plan year following the plan year in which it was contributed, the cash or deferred arrangement (in the case of an excess contribution) or the entire plan (in the case of an excess aggregate contribution) will lose its qualified status with respect to the plan year in which the contribution was made, and for each year thereafter in which the excess contribution or excess aggregate contribution remains in the account.

Notice 87-2, 1987-1 C.B. 396, provides model amendments that plan sponsors (excluding master or prototype plan sponsors) may adopt to conform to post-TRA qualification requirements, effective for plan years beginning before January 1, 1989. The formula in Notice 87-2 for allocating income to excess amounts requires that a corrective distribution be increased by the amount of net gains allocable to the excess amount, but provides that a corrective distribution shall not be reduced by the amount of net losses allocable to the excess amount.

Notice 87-33, 1987-1 C.B. 480, provides model amendments for adoption by master and prototype plan sponsors. Notice 87-34, 1987-1 C.B. 490, provides a model amendment that may be used by master or prototype plan sponsors who wish to adopt a qualified cash or deferred arrangement under section 401(k). The formulas in these notices for allocating income to excess amounts require plans to increase a corrective distribution by the amount of net gains allocable to the excess amount, and to reduce the corrective distribution by the amount of net losses allocable to the excess amount. Thus, where a plan experiences net losses, a corrective distribution (or forfeiture) computed in accordance with these notices (which provide for allocation of losses) will be smaller than a corrective distribution (or forfeiture) computed in accordance with Notice 87-2 (which does not provide for allocation of losses).

Notice 87-72, 1987-2 C.B. 381, permits plan sponsors (other than master and prototype plan sponsors), who have adopted or intend to adopt the model amendments of Notice 87-2, to modify the model language to allocate losses to excess amounts. This permits such plan sponsors to adopt a loss allocation formula similar to those available to master and prototype plan sponsors under Notices 87-33 and 87-34.

Notice 87-77, 1987-2 C.B. 385, provides guidance on when corrective distributions of excess amounts must be made and when corrective distributions will be includible in income; on how to reflect the corrective distributions of such excess amounts on information returns; and on the applicability of employment and withholding taxes to corrective distributions.

Allocation of Income to Excess Amounts

For correction of 1987 excess amounts, plan sponsors may use any reasonable method for allocating gain and loss to such amounts, provided that such method is used consistently for all participants and for all corrective distributions under a plan for the 1987 taxable or plan year (whichever is applicable). The methods provided in Notice 87-2 (with or without the modification permitted by Notice 87-72) and in Notices 87-33 and 87-34, collectively designated the Closing Balance Method, will be deemed reasonable methods. In addition, the Adjusted Balance Method provided in this notice will be deemed a reasonable method of determining the gain or loss allocable to an excess amount for the 1987 taxable or plan year.

Under the Closing Balance Method or the Adjusted Balance Method, the income allocable to the excess must be determined by computing both the income for the applicable year and the income for the period between the end of the year and the date of distribution (the gap period). This notice demonstrates the calculation of allocable income for such periods under both the Closing Balance Method and the Adjusted Balance Method. It also provides an additional method, the Ten-Percent Method, that will be deemed a reasonable method for calculating the gap period income.

The Ten-Percent Method may only be used to calculate gap period income; it may not be used to calculate the income for the applicable year. However, it may be used to calculate gap period income in conjunction with any reasonable method for calculating income for the applicable year. For example, it may be used in conjunction with the Closing Balance Method provided in model amendments under Notices 87-2, 87-33, and 87-34, even though such model amendments do not expressly provide for the Ten-Percent Method.

I. *Closing Balance Method*

Under the Closing Balance Method of Notices 87-2, 87-33, and 87-34, the income allocable to the excess is equal to the sum of (1) the income allocable to the account containing the excess amounts for the applicable year and (2) the income allocable to such account for the gap period, multiplied by a fraction. The numerator of the fraction is the excess amount, and the denominator is the closing balance (as of the end of the applicable year) of the account containing the excess amount. The closing balance includes income for the applicable year.

Example 1. Participant A made an elective contribution of $30,000 to a qualified cash or deferred arrangement under section 401(k) during 1987, resulting in an excess deferral for 1987 of $23,000. A had an opening account balance of $80,000. The gain allocable for the calendar year to the elective contribution account is $15,000. The gain allocable for the gap period, January 1, 1988 to March 1, 1988 (the date of distribution), is $5,000. The 1987 closing elective deferral account balance for A is $125,000, determined as follows: $80,000 opening account balance plus $15,000 gain earned through the end of the taxable year plus the $30,000 elective contribution. Under the Closing Balance Method, the income allocable to the excess deferral for the 1987 taxable year is $2,760 ($15,000 multiplied by 23,000/125,000). The income for the gap period is $920 ($5,000 multiplied by 23,000/125,000). Thus, under the Closing Balance Method, the income allocable to the excess deferral is $3,680 ($2,760 plus 920). The same result would be obtained by multiplying the combined income for the applicable year and gap period ($20,000) by the Closing Balance Method fraction (23,000/125,000). In either case, the amount of income subject to distribution is $3,680. Thus, the amount required to be distribted is $26,680 ($23,000 excess plus $3,680 income).

II. *Adjusted Balance Method*

Regulations under sections 401(k) and 401(m) will provide that gains and losses are to be allocated to excess amounts (with respect to both the applicable year and the gap period) on the basis of the Adjusted Balance Method described in this notice. The Adjusted Balance Method computes the income allocation on the basis of closing account balances (determined as of the end of the applicable year and as of the end of the gap period) adjusted for gains and losses during the applicable period. The formula under the Adjusted Balance Method is identical to that of the Closing Balance Method, except that the closing account balance is reduced by gains allocable to the account during the applicable period, and increased by losses allocable to such account during such period.

Example 2. Assume the facts set forth in Example 1. The elective deferral account balance for the end of the year is $125,000. Under the Adjusted Balance Method, the denominator of the fraction, $110,000, is computed by subtracting from the account balance ($125,000), the gain allocable to the account, ($15,000). Thus, the income allocable to the excess deferral for the 1987 taxable year is $3,136.36 ($15,000 income multiplied by 23,000/110,000). For purposes of computing the gap period income under the Adjusted Balance Method, the elective deferral account balance on the date of distribution is $130,000 ($125,000 opening balance on January 1, 1988 plus $5,000 earnings through the date of distribution). The denominator of the fraction is $125,000 ($130,000 minus 5,000). The income allocable to the excess deferral for the gap period under the Adjusted Balance Method is $920 ($5,000 multiplied by 23,000/125,000). Thus, under the Adjusted Balance Method, the total income allocable to the excess deferral in this example is $4,056.36 ($3.136.36 plus 920). The amount required to be distributed is $27,056.36 ($23,000 excess plus $4,056.36 income).

III. *Ten-Percent Method*

Regulations under section 401(k) and 401(m) will provide that the income allocable to an excess amount for the gap period may be determined under the following Ten-Percent Method. Under the Ten-Percent method, the allocable income for the gap period may be deemed to be equal to 10% of the income or loss allocable to the distributable excess for the applicable year multiplied by the number of calendar months that have elapsed since the end of the applicable year. A distribution occurring on or before the fifteenth day of the month will be treated as having been made on the last day of the preceding month, and a distribution occurring after such fifteenth day shall be treated as having been made on the first day of the next month. The income for the applicable year may not be calculated under the Ten-Percent Method.

Example 3. Assume the same facts as in Example 1, except that gap period income will be computed pursuant to the Ten-Percent Method. The gap period income allocable to the excess amount described in Example 1 is $552.00 (10% of $2,760.00 multiplied by the number of months (two) between the end of the year and the date of the corrective distribution). The total income allocable to the excess amount using the Ten-Percent Method in conjunction with the Closing Balance Method is $3,312.00 ($2,760.00 plus 552.00). Accordingly, the amount required to be distributed is $26,312.00 ($23,000 excess plus $3,312.00 income).

Example 4. Assume the same facts as in Example 2, except that gap period income will be computed pursuant to the Ten-Percent Method. The gap period income allocable to the excess amount described in Example 2 is $627.27 (10% of 3,136.36 multiplied by the number of months (two) between the end of the year and the date of the corrective distribution). The total income allocable to the excess amount using the Ten-Percent Method in conjunction with the Adjusted Balance Method is $3,763.63 ($3,136.36 plus 627.27). Accordingly, the amount required to be distributed is $26,763.63 ($23,000 excess plus $3,763.63 income).

Excess Contributions and Excess Aggregate Contributions

The foregoing examples of income allocation are based on excess deferrals, but similar formulas apply with respect to excess contributions and excess aggregate contributions. In the case of excess contributions, the numerator of the fraction is the total amount of excess contributions for the plan year, and the denominator of the fraction is the sum of the account balances attributable to the accounts containing such excess contributions (i.e. the sum of the accounts including the participant's elective deferrals, qualified matching contributions treated as elective deferrals, and the qualified nonelective contributions treated as elective deferrals). In the case of excess aggregate contributions, the numerator is the total amount of excess aggregate contributions for the plan year, and the denominator is the sum of the account balances containing such excess aggregate contributions (i.e. the accounts attributable to employee contributions, to matching contributions, and to elective deferrals and qualified nonelective contributions treated as matching contributions, if any). As in the case of elective deferrals, the foregoing denominators are unadjusted for gains and losses if the Closing Balance Method applies, or are adjusted for gains and losses if the Adjusted Balance Method applies.

Special Rule for Model Plan Adopters

Notwithstanding their adoption of the Closing Balance model language contained in Notices 87-2, 87-33, or 87-34, plan sponsors and employers who have adopted plans using the model amendments may calculate the income allocable to the excess amounts for the 1987 taxable or plan year pursuant to the Adjusted Balance Method, and may calculate the gap period income pursuant to either the Adjusted Balance Method or the Ten-Percent Method.

Definition of Highly Compensated Employee

Regulations under section 401(k) and (m) will provide that no penalties or plan disqualification will result from an error in the amount of excess contributions or excess aggregate contributions provided the following requirements are met:

(1) such failure or error resulted solely from an error in determining the group of highly compensated employees which error reflected a reasonable interpretation of the provisions of section 414(q) relied upon by the employer in defining highly compensated employee; and

(2) the excess contributions or excess aggregate contributions are with respect to plan years commencing with or during the 1987 calendar year and ending prior to July 1, 1988.

The following examples are illustrative of potential sources of differences in determining the group of highly compensated employees that will generally be considered reasonable interpretations of section 414(q) for purposes of this rule: (1) exclusion of collective bargaining employees in determining the number of employees in the top-paid group; (2) determination of the number of employees in the top-paid group on the basis of the total number of active employees at the end of the determination year and look-back year respectively; (3) use of the employer's fiscal year ending in the plan year for the determination year and use of the preceding fiscal year for the look-back year; (4) use of the 1986 and 1987 calendar years for the look-back year and determination year respectively.

In addition, regulations will provide that plans subject to the requirements of section 401(k) and (m) that have short plan years commencing in the 1987 or 1988 calendar years are eligible to elect the transitional rule in §1.414(q)1 A-15 for such years. For purposes of determining whether employees in such plans are five-percent owners or receive compensation in excess of $50,000, the employer must take into account the twelve month period ending with the last day of the short plan year.

Computation of Corrective Distribution Amount

In general, the excess amount to be distributed must be adjusted for gains and losses. However, excess amounts may be distributed without regard to losses in the following circumstances:

(1) Excess deferrals (but not excess contributions or excess aggregate contributions) for 1987 may be distributed without reduction for losses. Such distributions may require a plan amendment, but the sponsor may utilize the extended period provided under section 1140 of the TRA for making such amendments.

(2) If a plan sponsor adopts timely the model amendments in Notice 87-2, excess deferrals, excess contributions, and excess aggregate contributions may be distributed without reduction for losses until further guidance is issued by the Service.

Notice 87-77 Amplified

Plan sponsors and fiduciaries are reminded that corrective distributions of 1987 excesses made in 1988 are to be reported to participants on 1988 Forms W-2P and 1099-R. Payors and plan administrators need not furnish the 1988 Form W-2P or 1099-R to participants until the regular deadline for such reporting (January 31, 1989), but must advise plan participants at the time of distribution of the year in which the distribution is includible in income and that receipt of amounts includible in income in a prior year will require a participant to file an amended income tax return if a return has already been filed for that year. The 30-day notice requirement described in Notice 87-77 (with respect to corrective distributions of 1987 excess contributions and excess aggregate contributions made after the 2 1/2 month period and with respect to recharacterized amounts), can be satisfied either by providing the employer a copy of the completed 1988 Form W-2P or 1099-R or by providing the employer a written statement containing the information that the plan administrator or the payor would have been required to provide to the employer on the 1988 Form W-2P or 1099-R.

Reporting a Loss on 1987 Form 1040

If a 1987 net loss with respect to a corrective distribution of an excess deferral is incurred, such loss may be reported on 1987 Form 1040, Line 21, Other Income, as a bracketed (negative) numerical amount. Identify it as a "Loss on Excess Deferral Distribution." The full amount of the excess deferral will be reported as income on Line 7 of the 1987 Form 1040.

Reliance

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Gasohol Blenders and Sellers of Gasoline—Transitional Procedures

Notice 88-34

The purpose of this Notice is to inform gasohol blenders and sellers of gasoline that the transitional procedures provided in Notice 88-2, page 473, this Bulletin, for the first quarter of 1988 will continue to be effective through June 30, 1988. Under that procedure, a reduced rate of tax under section 4081(c)(1) of the Internal Revenue Code of 1986 ("the Code") applies to sales of gasoline to registered gasohol blenders only if the gasoline is or will be blended with alcohol to produce gasohol. Registered gasohol blenders are also reminded that they must file a Quarterly Federal Excise Tax Return (Form 720) for the second quarter of 1988 and maintain certain records, as provided in Notice 88-2, if they purchase gasoline to blend with alcohol to produce gasohol at the reduced rate of tax.

For the reduced rate of tax to apply to a sale to a gasohol blender, the blender must have complied with the registration and bond requirements of section 4101 of the Code. Thus, any gasohol blender that wishes to purchase gasoline to blend with alcohol to produce gasohol at the reduced rate of tax provided under section 4081(c)(1) must apply for registration on a Form 637 with the district director and obtain a registration number that signifies gasohol blender. Use of registration as a blender to purchase gasoline at the reduced rate that is not to be used to blend with alcohol to produce gasohol is a misuse of the registration and may lead to revocation or suspension of the registration.

Section 4101 of the Code provides that persons registering under section 4101 may be required to give a bond. Effective April 1, 1988, a gasohol blender that wishes to purchase gasoline to blend with alcohol to produce gasohol at the reduced rate of tax may be required to give a bond if the district director is not satisfied with the blender's federal tax filing, deposit, and payment history. *See* I.R.S. Notice 88-16, page 482, this Bulletin.

Final regulations will clarify that if a bond is required, effective July 1, 1988, the amount of the bond will be equal to the lesser of (1) $1,000,000 or (2) an amount equal to 5-2/3 cents multiplied by the number of gallons of gasoline the gasohol blender expects to purchase at the reduced rate of tax provided under section 4081(c)(1) in an average 1-month period (as determined by the district director). This calculation of the amount of a bond that may be required of a gasohol blender that purchases gasoline to blend with alcohol to produce gasohol at the reduced rate of tax under section 4081(c)(1) after June 30, 1988, may result in a bond amount different from the amount required under the proposed regulations published in the Federal Register on November 18, 1987 (52 FR 44141) or in Notice 88-16. Therefore, this portion of the proposed regulations, as revised, will be issued in proposed form before being issued in final form.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Section 933.—Income From Sources Within Puerto Rico: 1986 Tax Reform Act Changes Affecting United States Citizens Who Are Bona Fide Residents of Puerto Rico

Notice 88-35

The Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 1 (the Act), changed the tax treatment of deductions for age and blindness and of income from sales of stock and other personal property. This notice describes how these changes affect United States citizens who are bona fide residents of Puerto Rico ("citizen residents").

BACKGROUND

Section 933 of the Internal Revenue Code of 1986 provides that income derived from sources within Puerto Rico by a bona fide resident of Puerto Rico is excludable from gross income. If the resident is a United States citizen, however, the resident's income from sources outside Puerto Rico remains subject to tax under normal United States tax rules.

DEDUCTIONS FOR AGE AND BLINDNESS

Section 933(1) of the Code provides that deductions allocable to Puerto Rican source income may not be claimed against other income by a citizen resident. A citizen resident's deductions must be apportioned between Puerto Rican source income and other income under principles similar to those set forth in section 861(b). Deductions allowed under section 151 (relating to personal exemptions), however, are excepted from this rule and may be claimed by a citizen resident against non-Puerto Rican source income.

For taxable years before 1987, sections 151(c) and (d) of the Internal Revenue Code of 1954 allowed deductions for age and blindness exemptions. Under section 933, the full amount of these deductions could be claimed against the taxable income of citizen residents.

For taxable years beginning after December 31, 1986, the Act removed these deductions from section 151 of the Code, and provided instead additional standard deductions (based on age and blindness) under section 63(f). Like other deductions and the former zero bracket amount, therefore, these deductions must now be apportioned between Puerto Rican source income and other income. Citizen residents may deduct only the amount apportioned to other income.

SALES OF STOCK AND OTHER PERSONAL PROPERTY

Section 865 of the Code, added by the Act, provides that for taxable years beginning after December 31, 1986, the source of income from the sale of personal property is the seller's country of residence. Section 865(g)(2) provides that United States citizens will be treated as residents of the United States for purposes of section 865 unless the taxpayer pays to a foreign country (including, for this purpose, Puerto Rico) a tax on the sales income at an effective rate of at least ten percent. Therefore, if a citizen resident recognizes gain from the sale of stock or other personal property, the gain is excludable from gross income under section 933 only if the individual pays a tax on the gain to Puerto Rico at an effective rate of at least ten percent.

Tiered Structure—Section 444 Election

Notice 88-36

This notice provides guidance regarding the definition of the term "tiered structure" under section 444(d)(3) of the Internal Revenue Code.

I. Background

Sections 441(i), 706(b), and 1378 of the Code, as amended by section 806 of the Tax Reform Act of 1986 (Pub. L. 99-514)—(the "1986 Act"), [1986-3 (Vol. 1) C.B. 279], generally require personal service corporations, partnerships, and S corporations, respectively, to conform their taxable years to the taxable years of their owner.

New section 444 of the Code, as added by section 10206 of the Omnibus Budget Reconciliation Act of 1987 (Pub. L. 100-203)—(the "1987 Act"), allows certain partnerships, S corporations and personal service corporations to elect the use of a taxable year that is different from the taxable year that such entities would otherwise be required to use under section 806 of the 1986 Act.

Under section 444(d)(3) of the Code, a partnership, S corporation, or personal service corporation that is a member of a tiered structure generally may not make a section 444 election to use a particular taxable year for Federal income tax purposes. The Internal Revenue Service has received many inquiries regarding the definition of tiered structure under section 444(d)(3).

For additional background information, see section I (entitled "Background") and VII (entitled "Tiered Structures") of Notice 88-10, page 478, this Bulletin.

II. Summary of Guidance.

This notice provides that an entity that is a partnership, S corporation, or personal service corporation will be treated as a member of a tiered structure if such entity directly owns any portion or a "deferral entity," or is directly owned (in whole or in part) by a "deferral entity." The term "deferral entity" is defined to include partnerships, S corporations, personal service corporations and certain trusts.

This notice also contains two de minimis rules which allow certain deferral entities to be disregarded for purposes of determining whether a partnership, S corporation, or personal service corporation is a member of tiered structure. For those provisions, as well as additional rules relating to the determination of membership in a tiered structure, see the "Detailed Guidance" section of this notice.

The rules provided in the "Detailed Guidance" section of this notice will be included in forthcoming temporary regulations. However, neither the release of this notice nor the publication of this notice in the Internal Revenue Bulletin will commence the running of the 60-day period described in section III of Notice 88-10 (page 478) for making a section 444 election. Rather, as provided in section III of Notice 88-10, such election period will commence with the publication of the forthcoming temporary regulations in the Federal Register.

III. Detailed Guidance.

The following guidance is provided relating to section 10206 of the Omnibus Budget Reconciliation Act of 1987.

Table of Contents

(c) Tiered Structure.
  (1) General rule.
  (2) Definition of a member of a tiered structure.
    (i) In general.
    (ii) Deferral entity.
      (A) In general.
      (B) Exception.
    (iii) Anti-abuse rule.
  (3) De minimis rules.
    (i) In general.
    (ii) Downstream de minimis rule.
      (A) General rule.
      (B) Definition of testing period.
      (C) Definition of adjusted taxable income.
        (*1*) Partnership.
        (*2*) S corporation.
        (*3*) Personal service corporation.
      (D) Special rules.
        (*1*) Pro-forma rule.
        (*2*) Reasonable estimates allowed.
        (*3*) Newly formed entities.
          (*i*) Newly formed deferral entities.
          (*ii*) Newly formed partnership, S corporation, or personal

service corporation desiring to make a section 444 election.

(iii) Upstream de minimis rule.

(4) Date for determining the existence of a tiered structure.

(i) General rule.

(ii) Special rule for taxable years beginning in 1987.

(5) Same taxable year exception.

(i) In general.

(ii) Definition of tiered structure.

(A) General rule.

(B) Special flow-through rule for downstream controlled partnerships.

(iii) Determining the taxable year of a partnership or S corporation.

(iv) Special rule for 52-53 week taxable years.

(v) Interaction with de minimis rules.

(A) Downstream de minimis rule.

(*1*) In general.

(*2*) Special rule for members of a tiered structure directly owned by a downstream controlled partnership.

(B) Upstream de minimis rule.

(6) Examples.

(c) *Tiered structure*—(1) *General rule*. Except as provided in paragraph (c)(5) of this section, no section 444 election shall be made or continued with respect to a partnership, S corporation, or personal service corporation that is a member of a tiered structure on the date specified in paragraph (c)(4) of this section. For purposes of this section, the term "personal service corporation" means a personal service corporation as defined in section 441(i)(2).

(2) *Definition of a member of a tiered structure*—(i) *In general*. A partnership, S corporation, or personal service corporation will be considered a member of a tiered structure if--

(A) The partnership, S corporation, or personal service corporation directly owns any portion of a deferral entity, or

(B) A deferral entity directly owns any portion of the partnership, S corporation, or personal service corporation.

However, see paragraph (c)(3) of this section for certain de minimis rules, and see paragraph (c)(2)(iii) of this section for an anti-abuse rule. In addition, for purposes of this section, a beneficiary of a trust shall be considered to own an interest in the trust.

(ii) *Deferral entity*—(A) *In general*. For purposes of this section, the term "deferral entity" means an entity that is a partnership, S corporation, personal service corporation, or trust.

(B) *Exception*. Notwithstanding paragraph (c)(2)(ii)(A) of this section, the term "deferral entity" does not include a trust (or a portion of a trust) which is treated as owned by the grantor or beneficiary under Subpart E, part I, subchapter J, chapter 1, of the Code (relating to grantor trusts), including a trust that is treated as a grantor trust pursuant to section 1361(d)(1)(A) of the Code (relating to qualified subchapter S trusts).

(iii) *Anti-abuse rule*. Notwithstanding paragraph (c)(2)(i) of this section, a partnership, S corporation, or personal service corporation is considered a member of a tiered structure if the partnership, S corporation, personal service corporation, or related taxpayers have organized or reorganized their ownership structure or operations for the principal purpose of obtaining a significant unintended tax benefit from making or continuing a section 444 election. For purposes of the preceding sentence, a significant unintended tax benefit results when a partnership, S corporation, or personal service corporation makes a section 444 election and, as a result, a taxpayer (not limited to the entity making the election) obtains a significant deferral of income substantially all of which is not eliminated by a required payment under section 7519. See examples (15) through (19) in paragraph (c)(6) of this section.

(3) *De minimis rules*—(i) *In general*. For rules relating to a de minimis exception to paragraph (c)(2)(i)(A) of this section (the "downstream de minimis rule"), see paragraph (c)(3)(ii) of this section. For rules relating to a de minimis exception to paragraph (c)(2)(i)(B) of this section (the "upstream de minimis rule"), see paragraph (c)(3)(iii) of this section. For rules relating to the interaction of the de minimis rules provided in this paragraph (c)(3) and the "same taxable year exception" provided in paragraph (c)(5) of this section, see paragraph (c)(5)(v) of this section.

(ii) *Downstream de minimis rule*—(A) *General rule*. If a partnership, S corporation, or personal service corporation directly owns any portion of one or more deferral entities as of the date specified in paragraph (c)(4) of this section, such ownership is disregarded for purposes of paragraph (c)(2)(i)(A) of this section if, in the aggregate, all such deferral entities accounted for--

(*1*) Not more than 5 percent of the partnership's, S corporation's, or personal service corporation's adjusted taxable income for the testing period ("5 percent adjusted taxable income test"), or

(*2*) Not more than 2 percent of the partnership's, S corporation's, or personal service corporation's gross income for the testing period ("2 percent gross income test"). See section 702(c) for rules relating to the determination of gross income of a partner in a partnership.

See examples (3) through (5) in paragraph (c)(6) of this section.

(B) *Definition of testing period*. For purposes of paragraph (c)(3)(ii), the term "testing period" means the taxable year that ends immediately prior to the taxable year for which the partnership, S corporation, or personal service corporation desires to make or continue a section 444 election. However, see the special rules provided in paragraph (c)(3)(ii)(D) of this section for certain special cases (*e.g.*, the partnership, S corporation, personal service corporation or deferral entity was not in existence during the entire testing period). The following example illustrates the application of this paragraph (c)(3)(ii)(B).

Example. A partnership desires to make a section 444 election for its taxable year beginning November 1, 1987. The testing period for purposes of determining whether deferral entities owned by such partnership are de minimis under paragraph (c)(3)(ii) of this section is the taxable year ending October 31, 1987. If either the partnership or the deferral entities were not in existence for the entire taxable year ending October 1, 1987, see the special rules provided in paragraph (c)(3)(ii)(D) of this section.

(C) *Definition of adjusted taxable income*—(*1*) *Partnership*. In the case of a partnership, adjusted taxable income for purposes of paragraph (c)(3)(ii) of this section is an amount equal to the sum of the—

(*i*) Aggregate amount of the partnership items described in section 702(a) (other than credits and tax-exempt income),

(*ii*) Applicable payments defined in section 7519(d)(3) that are deducted in determining the amount described in paragraph (c)(3)(ii)(C)(*1*)(*i*) of this section, and

(*iii*) Guaranteed payments defined in section 707(c) that are deducted in determining the amount described in paragraph (c)(3)(ii)(C)(*1*)(*i*) of this section and are not otherwise included in paragraph (c)(3)(ii)(C)(*1*)(*ii*) of this section.

For purposes of determining the aggregate amount of partnership items under paragraph (c)(3)(ii)(C)(*1*)(*i*) of this section, deductions and losses are treated as negative income. Thus, for example, if under section 702(a) a partnership has $1,000 of ordinary taxable income, $500 of specially allocated deductions, and $300 of capital loss, the partnership's aggregate amount of partnership items under paragraph (c)(3)(ii)(C)(*1*)(*i*) of this section is $200 ($1,000 - $500 - $300).

(*2*) *S corporation.* In the case of an S corporation, adjusted taxable income for purposes of paragraph (c)(3)(ii) of this section is an amount equal to the sum of the—

(*i*) Aggregate amount of the S corporation items described in section 1366(a) (other than credits and tax-exempt income), and

(*ii*) Applicable payments defined in section 7519(d)(3) that are deducted in determining the amount described in paragraph (c)(3)(ii)(C)(*2*)(*i*) of this section, deductions and losses are treated as negative income. Thus, for example, if under section 1366 (a) an S corporation has $2,000 of ordinary taxable income, $1,000 of deductions described in section 1366(a)(1)(A) of the Code, and $500 of capital loss, the S corporation's aggregate amount of S corporation items under paragraph (c)(3)(ii)(C)(*2*)(*i*) of this section is $500 ($2,000 - $1,000 - $500).

(*3*) *Personal service corporation.* In the case of a personal service corporation, adjusted taxable income for purposes of paragraph (c)(3)(ii) of this section is an amount equal to the sum of the—

(*i*) Taxable income of the personal service corporation, and

(*ii*) Applicable amounts defined in section 280H(f)(1) that are deducted in determining the amount described in paragraph (c)(3)(ii)(C)(*3*)(*i*) of this section.

(D) *Special rules*—(*1*) *Pro-forma rule.* Except as provided in paragraph (c)(3)(D)(*3*)(*ii*), if a partnership, S corporation, or personal service corporation directly owns any interest in a deferral entity as of the date specified in paragraph (c)(4) of this section and such ownership interest is different in amount from the partnership's, S corporation's, or personal service corporation's interest on any day during the testing period, the 5 percent adjusted taxable income test and the 2 percent gross income test must be applied on a pro-forma basis (*i.e.*, adjusted taxable income and gross income must be calculated for the testing period assuming that the partnership, S corporation, or personal service corporation owned the same interest in the deferral entity that it owned as of the date specified in paragraph (c)(4) of this section). The following example illustrates the application of this paragraph (c)(3)(ii)(D)(*1*).

Example. A personal service corporation desiring to make a section 444 election for its taxable year beginning October 1, 1987, acquires a 25 percent ownership interest in a partnership on or after October 1, 1987. Furthermore, the partnership has been in existence for several years. The personal service corporation must modify its calculations of the 5 percent adjusted taxable income test and the 2 percent gross income test for the testing period ended September 30, 1987, by assuming that the personal service corporation owned 25 percent of the partnership during such testing period and the personal service corporation's adjusted taxable income and gross income were correspondingly adjusted.

(*2*) *Reasonable estimates allowed.* If the information necessary to complete the pro-forma calculation described in paragraph (c)(3)(ii)(D)(*1*) is not readily available, the partnership, S corporation, or personal service corporation may make a reasonable estimate of such information.

(*3*) *Newly formed entities*—(*i*) *Newly formed deferral entities.* If a partnership, S corporation, or personal service corporation owns any portion of a deferral entity on the date specified in paragraph (c)(4) of this section and such deferral entity was not in existence during the entire testing period (hereinafter referred to as a "newly formed deferral entity"), both the 5 percent adjusted taxable income test and the 2 percent gross income test are modified as follows. First, the partnership, S corporation, or personal service corporation shall calculate the percentage of its adjusted taxable income or gross income that is attributable to deferral entities, excluding newly formed deferral entities. Second, the partnership, S corporation, or personal service corporation shall calculate (on the date specified in paragraph (c)(4) of this section) the percentage of the tax basis of its assets that are attributable to its tax basis with respect to its ownership interests in all newly formed deferral entities. If the sum of the two percentages is 5 percent or less, the deferral entities are considered de minimis and are disregarded for purposes of paragraph (c)(2)(i)(A) of this section. If the sum of the two percentages is greater than 5 percent, the deferral entities do not qualify for the de minimis rule provided in paragraph (c)(2)(i)(A) of this section and thus the partnership, S corporation, or personal service corporation is considered to be a member of a tiered structure for purposes of this section.

(*ii*) *Newly formed partnership, S corporation, or personal service corporation desiring to make a section 444 election.* If a partnership, S corporation, or personal service corporation desires to make a section 444 election for the first taxable year of its existence, the 5 percent adjusted taxable income test and the 2 percent gross income test are replaced by a 5 percent of assets test. Thus, if on the date specified in paragraph (c)(4) of this section, 5 percent or less of the assets (measured by reference to the tax basis of the assets) of the newly formed partnership, S corporation, or personal service corporation are attributable to the tax basis with respect to its ownership interests in the deferral entities, the deferral entities will be considered de minimis and will be disregarded for purposes of paragraph (c)(2)(i)(A) of this section.

(iii) *Upstream de minimis rule.* If a partnership, S corporation or personal service corporation is directly owned by one or more deferral entities as of the date specified in paragraph (c)(4) of this section, such ownership is disregarded for purposes of paragraph (c)(2)(i)(B) of this section if deferral entities directly own, in the aggregate, 5 percent or less of—

(A) An interest in the current profits of the partnership, or

(B) The stock (measured by value) of the S corporation or personal service corporation.

See examples (6) and (7) in paragraph (c)(6) of this section.

(4) *Date for determining the existence of a tiered structure*—(i) *General rule.* For purposes of paragraph (c)(1) of this section, a partnership, S corporation, or personal service corporation will be considered a member of a tiered structure for a particular taxable year if the partnership, S corporation, or personal service corporation is a member of a tiered structure on the last day of the required taxable year (as defined in section 444(e) of the Code) for such year. The following example illustrates the application of this paragraph (c)(4)(i).

Example. Assume that a newly formed partnership whose first taxable year begins November 1, 1988, desires to adopt a September 30 taxable year by making a section 444 election. Furthermore, assume that for its taxable year beginning November 1, 1988, the partnership's required taxable year is December 31. If the partnership is a member of a tiered structure on December 31, 1988, it will not be eligible to make a section 444 election for a taxable year beginning November 1, 1988, and ending September 30, 1989.

(ii) *Special rule for taxable years beginning in 1987.* For purposes of paragraph (c)(1) of this section, a partnership, S corporation, or personal service corporation will not be considered a member of a tiered structure for a taxable year beginning in 1987 if the partnership, S corporation, or personal service corporation is not a member of a tiered structure on the day the partnership, S corporation, or personal service corporation timely files its section 444 election for such year. The following examples illustrate the application of this paragraph (c)(4)(ii).

Example (1). Assume that a partnership desires to retain a June 30 taxable year by making a section 444 election for its taxable year beginning July 1, 1987. Furthermore, assume that the partnership's required taxable year for such year is December 31 and that the partnership was a member of a tiered structure on such date. Also assume that the partnership was not a member of a tiered structure as of the date it timely filed its section 444 election for its taxable year beginning July 1, 1987. Based upon the special rule provided in this paragraph (c)(4)(ii), the partnership will not be considered a member of tiered structure for its taxable year beginning July 1, 1987.

Example (2). Assume the same facts as in example (1), except that the partnership was a member of a tiered structure on the date it filed its section 444 election for its taxable year beginning July 1, 1987, but was not a member of a tiered structure on December 31, 1987. Paragraph (c)(4)(i) of this section would still apply and thus the partnership would not be considered part of a tiered structure for its taxable year beginning July 1, 1987. However, the partnership would be considered a member of a tiered structure for its taxable year beginning July 1, 1988, if the partnership was a member of a tiered structure on December 31, 1988.

(5) *Same taxable year exception*—(i) *In general.* Although a partnership or S corporation is a member of a tiered structure as of the date specified in paragraph (c)(4) of this section, the partnership or S corporation may make or continue a section 444 election if the tiered structure (as defined in paragraph (c)(5)(ii) of this section) consists entirely of partnerships or S corporations (or both), all of which have the same taxable year as determined under paragraph (c)(5)(iii) of this section. However, see paragraph (c)(5)(v) of this section for the interaction of the de minimis rules provided in paragraph (c)(3) of this section with the same taxable year exception. For purposes of this paragraph (c)(5), two or more entities are considered to have the same taxable year if their taxable years end on the same day, even though they begin on different days. See exceptions (8) through (14) in paragraph (c)(6) of this section.

(ii) *Definition of tiered structure*—(A) *General rule.* For purposes of the same taxable year exception the members of atiered structure are defined to include the following entities—

(*1*) The partnership or S corporation that desires to qualify for the same taxable year exception,

(*2*) A deferral entity (or entities) directly owned (in whole or in part) by the partnership or S corporation that desires to qualify for the same taxable year exception,

(*3*) A deferral entity (or entities) directly owning any portion of the partnership or S corporation that desires to qualify for the same taxable year exception, and

(*4*) A deferral entity (or entities) directly owned (in whole or in part) by a "downstream controlled partnership," as defined in paragraph (c)(5)(ii)(B) of this section.

(*B*) *Special flow-through rule for downstream controlled partnerships.* If more that 50 percent of a partnership's profits and capital are owned by a partnership or S corporation that desires to qualify for the same taxable year exception, such owned partnership is considered a downstream controlled partnership for purposes of paragraph (c)(5)(ii)(A) of this section. Furthermore, if more than 50 percent of a partnership's profits and capital are owned by a downstream controlled partnership, such owned partnership is considered a downstream controlled partnership for purposes of paragraph (c)(5)(ii)(A) of this section.

(iii) *Determining the taxable year of a partnership or S corporation.* The taxable year of a partnership or S corporation to be taken into account for purposes of paragraph (c)(5)(i) of this section is the taxable year ending with or prior to the date specified in paragraph (c)(4) of this section. Furthermore, the determination of such taxable year will take into consideration any section 444 elections made by the partnership or S corporation. See examples (10) and (11) in paragraph (c)(6) of this section.

(iv) *Special rule for 52–53-week taxable years.* For purposes of this paragraph (c)(5), a 52–53-week taxable year with reference to the end of a particular month will be considered to be the same as a taxable year ending with reference to the last day of such month.

(v) *Interaction with de minimis rules*—(A) *Downstream de minimis rule*—(*1*) *In general.* If a partnership or S corporation that desires to make or continue a section 444 election is a member of a tiered structure (as defined in paragraph (c)(5)(ii) of this section) and directly owns any member (or members) of the tiered structure with a taxable year different from the taxable year of the partnership or S corporation, such ownership is disregarded for purposes of the same taxable year exception of paragraph (c)(5)(i) of this section provided that, in the aggregate, the de minimis rule of (c)(35)(ii) of this section is satisfied with respect to such owned member (or members). The following example illustrates the application of this paragraph (c)(5)(v)(A)(*1*).

Example. P, a partnership with a June 30 taxable year, owns 60 percent of P1, another partnership with a June 30 taxable year. P also owns 1 percent of P2 and P3, calendar year partnerships. If, in the aggregate, P's ownership interests in P2 and P3 are considered de minimis under paragraph (c)(3)(ii) of this section, P meets the same taxable year exception and may make a section 444 election to retain its June 30 taxable year.

(2) *Special rule for members of a tiered structure directly owned by a downstream controlled partnership.* For purposes of paragraph (c)(5)(v)(A)(*1*) of this section, a partnership or S corporation desiring to make or continue a section 444 election is considered to directly own any member of the tiered structure (as defined in paragraph (c)(5)(ii) of this section) directly owned by a downstream controlled partnership (as defined in paragraph (c)(5)(ii)(B) of this section). The adjusted taxable income or gross income of the partnership or S corporation that is attributable to a member of a tiered structure directly owned by a downstream controlled partnership equals the adjusted taxable income or gross income of such member multiplied by the partnership's or S corporation's indirect ownership percentage of such member. The following example illustrates the application of this paragraph (c)(5)(v)(A)(*2*).

Example. P, a partnership, desires to retain its June 30 taxable year by making section 444 election. However, as of the date specified in paragraph (c)—(4) of this section, P owns 75 percent of P1, a June 30 partnership, and P1 owns 40 percent of P2, a calendar year partnership. P also owns 25 percent of P3, a calendar year partnership. Pursuant to paragraphs (c)(5)(v)(A)(*1*) and (*2*) of this section, P may only qualify to use the same taxable year exception if, in the aggregate, P2 and P3 are de minimis with respect to P1. Pursuant to paragraph (c)(5)(v)(A)(*2*) of this section, P'S adjusted taxable income or gross income attributable to P2 equals 30 percent (75 percent times 60 percent) of P2's adjusted taxable income or gross income.

(B) *Upstream de minimis rule.* If a partnership or S corporation that desires to make or continue a section 444 election is a member of a tiered structure (as defined in paragraph (c)(5)(ii) of this section) and is owned directly by a member (or members) of the tiered structure with taxable years different from the taxable year of the partnership or S corporation, such ownership is disregarded for purposes of the same taxable year exception of paragraph (c)(5)(i) of this section provided that, in the aggregate, the de minimis rule of paragraph (c)(3)(iii) of this section is satisfied with respect to such owning member (or members). See example 12 of paragraph (c)(6) of this section.

(6) *Examples.* The provisions of this paragraph (c) may be illustrated by the following examples.

Example (1). A, a partnership, desires to make or continue a section 444 election. However, on the date specified in paragraph (c)(4) of this section, A is owned by a combination of individuals and S corporations. The S corporations are deferral entities, as defined in paragraph (c)(2)(ii) of this section. Thus, pursuant to paragraph (c)(2)(i)(B) of this section, A will be a member of a tiered structure unless under paragraph (c)(3)(iii) of this section, the S corporations, in the aggregate, own a de minimis portion of A. If the S corporations' ownership in A is not considered de minimis under paragraph (c)(3)(iii) of this section, A is a member of a tiered structure and will be allowed to make or continue a section 444 election only if it meets the same taxable year exception provided in paragraph (c)(5) of this section.

Example (2). B, a partnership, desires to make or continue a section 444 election. However, on the date specified in paragraph (c)(4) of this section, B is a partner in two partnerships, B1 and B2. B1 and B2 are deferral entities, as defined in paragraph (c)(2)(ii) of this section. Thus, under paragraph (c)(2)(i)(A) of this section, B will be a member of a tiered structure unless B's aggregate ownership interests in B1 and B2 are considered de minimis under paragraph (c)(3)(ii) of this section. If B is a member of a tiered structure on the date specified in paragraph (c)(4) of this section, B will be allowed to make or continue a section 444 election only if it meets the same taxable year exception provided in paragraph (c)(5) of this section.

Example (3). C, a partnership with a September 30 taxable year, is 100 percent owned by calendar year individuals. C desires to make a section 444 election for its taxable year beginning October 1, 1987. However, on the date specified in paragraph (c)(4) of this section, C owns a 1 percent interest in C1, a partnership. C does not own any other interest in a deferral entity. For the taxable year ended September 30, 1987, 10 percent of C's adjusted taxable income (as defined in paragraph (c)(3)(ii)(C) of this section) was attributable to C's partnership interest in C1. Furthermore, 4 percent of C's gross income for the taxable year ended September 30, 1987, was attributable to C's partnership interest in C1. Under paragraph (c)(3)(ii) of this section, C's partnership interest in C1 is not de minimis because during the testing period more than 5 percent of C's adjusted taxable income is attributable to C1 and more than 2 percent of C's gross income is attributable to C1. Thus, C is a member of a tiered structure for its taxable year beginning October 1, 1987.

Example (4). The facts are the same as example (3), except that for the taxable year ended September 30, 1987, only 2 percent of C's adjusted taxable income was attributable to C1. Under paragraph (c)(3)(ii) of this section, C's partnership interest in C1 is considered de minimis for purposes of determining whether C is a member of a tiered structure because not more than 5 percent of C's adjusted taxable income during the testing period is attributable to C1. Thus, C is not a member of a tiered structure for its taxable year beginning October 1, 1987.

Example (5). The facts are the same as example (4), except that in addition to owning C1, C also owns 15 percent of C2, another partnership. For the taxable year ended September 30, 1987, 2 percent of C's adjusted taxable income is attributable to C1 and an additional 4 percent is attributable to C2. Furthermore, for the taxable year ended September 30, 1987, 4 percent of C's gross income is attributable to C1 while 3 percent is attributable to C2. Under paragraph (c)(3)(ii) of this section, C1 and C2 must be aggregated for purposes of determining whether C meets either the 5 percent adjusted gross income test or the 2 percent gross income test. Since C's adjusted taxable income attributable to C1 and C2 is 6 percent (2 percent + 4 percent) and C's gross income attributable to C1 and C2 is 7 percent (4 percent + 3 percent), C does not meet the downstream de minimis rule provided in paragraph (c)(3)(ii) of this section. Thus, C is a member of a tiered structure for its taxable year beginning October 1, 1987.

Example (6). The facts are the same as example (3), except that instead of determining whether C is part of a tiered structure, the issue is whether C1 is part of a tiered structure, In addition, assume that on the date specified in paragraph (c)(4) of this section, the remaining 99 percent of C1 is owned by calendar year individuals and C1 does not own an interest in any deferral entity. Although C in Example (3) was considered to be a part of a tiered structure by virtue of its ownership interest in C1, C1 must be tested separately to determine whether it is part of a tiered structure. Since C's interest in C1 is 5 percent or less, C's interest in C1 is de minimis with respect to C1. See paragraph (c)(3)(iii) of this section. Thus, based upon these facts, C1 is not part of a tiered structure.

Example (7). The facts are the same as example (6), except that the remaining 99 percent of C1 is owned 94 percent by calendar year individuals and 5 percent by C3, another partnership. Thus, deferral entities own 6 percent of C1 (1 percent owned by C and 5 percent owned by C3). Under paragraph (c)(3)(iii) of this section, deferral entities own more than a de minimis interest (*i.e.*, 5 percent) of C1, and thus C1 is part of a tiered structure.

Example (8). D, a partnership with a September 30 taxable year, desires to make a section 444 election for its taxable year beginning October 1, 1987. On December 31, 1987, and the date D plans to file its section 444 election, D is 10 percent owned by D1, a personal service corporation with a September 30 taxable year, and 90 percent owned by calendar year individuals. Furthermore, D1 will retain its September 30 taxable year because it previously established a business purpose for such year. Since D is owned in part by D1, a personal service corporation, and the ownership interest is not de minimis under paragraph (c)(3)(iii) of this section, D is considered a member of a tiered structure for its taxable year beginning October 1, 1987. Furthermore, although D and D1 have the same taxable year, D does not qualify for the same taxable year exception provided in paragraph (c)(5) of this section because D1 is a personal service corporation rather than a partnership or S corporation. Thus, pursuant to paragraph (c)(1) of this section, D may not make a section 444 election for its taxable year beginning October 1, 1987.

Example (9). The facts are the same as example (8), except that D1 is a partnership rather than a personal service corporation. Based upon these facts, D qualifies for the same taxable year exception provided in paragraph (c)(5) of this section. Thus, D may make a section 444 election for its taxable year beginning October 1, 1987.

Example (10). The facts are the same as example (9), except that D1 has not established a business purpose for a September 30 taxable year. In addition, D1 does not desire to make a section 444 election and under section 706(b), D1 will be required to change to a calendar year for its taxable year beginning October 1, 1987. Pursuant to paragraph (c)(5)(iii) of this section, D and D1 do not have the same taxable year for purposes of the same taxable year exception provided in paragraph (c)(5) of this section. Thus, D may not make a section 444 election for its taxable year beginning October 1, 1987.

Example (11). The facts are the same as example (8), except that D1 is a partnership with a March 31 taxable year. Furthermore, for its taxable year beginning April 1, 1987, D1 will change to a September 30 taxable year by making a section 444 election. Pursuant to paragraph (c)(5)(iii) of this section, D1 is considered to have a September 30 taxable year for purposes of determining whether D qualifies for the same taxable year exception provided in paragraph (c)(5) of this section. Since both D and D1 will have the same taxable year as of the date specified in paragraph (c)(4) of this section, D may make a section 444 election for its taxable year beginning October 1, 1987.

Example (12). The facts are the same as example (11), except that instead of the remaining 90 percent of D being owned by calendar year individuals, it is owned 86 percent by individuals and 4 percent by D2, a calendar year partnership. Thus, D, a September 30 partnership, is 10 percent owned by D1, a September 30 partnership, 86 percent owned by calendar year individuals, and 4 percent owned by D2, a calendar year partnership. Under paragraph (c)(5)(v)(B) of this section, D2's ownership interest in D is considered de minimis for purposes of the same taxable year exception. Since D2's ownership interest in D is considered de minimis, it is disregarded for purposes of determining whether D qualifies for the same taxable year exception provided in paragraph (c)(5) of this section. Thus, since both D and D1 will have the same taxable year as of the date specified in paragraph (c)(4) of this section, D may make a section 444 election for its taxable year beginning October 1, 1987.

Example (13). E, a partnership with a June 30 taxable year, desires to make a section 444 election for its taxable year beginning July 1, 1987. On the date specified in paragraph (c)(4) of this section, E is 100 percent owned by calendar year individuals; E owns 99 percent of the profits and capital of E1, a partnership with a June 30 taxable year; and E1 owns 30 percent of the profits and capital of E2, a partnership with a September 30 taxable year. E owns no other deferral entities. Pursuant to paragraph (c)(2)(i)(A) of this section, E is considered to be a member of a tiered structure. Furthermore, pursuant to paragraph (c)(5) of this section, E does not qualify for the same taxable year exception because E2 does not have the same taxable year as E and E1.

Example (14). The facts are the same as example (13), except that E owns only 49 percent (rather than 99 percent) of the profits and capital of E1. Pursuant to paragraph (c)(5) of this section, E qualifies for the same taxable year exception because E and E1 have the same taxable year. Pursuant to paragraph (c)(5) of this section, E1's ownership interest in E2 is disregarded since E does not own more than 50 percent of E1's profits and capital.

Example (15). Prior to consideration of the anti-abuse rule provided in paragraph (c)(2)(iii) of this section, H, a partnership that commenced operations on October 1, 1987, is eligible to make a section 444 election for its taxable year beginning October 1, 1987. Although H may obtain a significant deferral of income substantially all of which is not eliminated by a required payment under section 7519 (since there will be no required payment for H's first taxable year), the anti-abuse rule of paragraph (c)(2)(iii) will not apply unless the principal purpose of organizing H was the attainment of a significant deferral of income that would result from making a section 444 election.

Example (16). F, a partnership with a January 31 taxable year, desires to make a section 444 election to retain its January 31 taxable year for the taxable year beginning February 1, 1987. F is 100 percent owned by calendar year individuals. Prior to the date specified in paragraph (c)(4) of this section, F contributes substantially all of its assets to F1, a partnership, in exchange for a 51 percent interest in F1. The remaining 49 percent of F1 is owned by the calendar year individuals owning 100 percent of F. If F is allowed to make a section 444 election to retain its January 31 taxable year, F1's required taxable year will be January 31 since a majority of F1's partners use a January 31 taxable year. F's principal purpose for creating F1 and contributing its assets to F1 is to obtain an 11-month deferral on 49 percent of the income previously earned by F and now earned by F1. Pursuant to paragraph (c)(2)(iii) of this section, F is not allowed to make a section 444 election for its taxable year beginning February 1, 1987.

Example (17). The facts are the same as in example (16), except that F does not create F1 and contribute its assets to F1 until immediately after F makes its section 444 election for the taxable year beginning February 1, 1987. Thus, F is allowed to make a section 444 election for its taxable year beginning February 1, 1987. However, pursuant to paragraph (c)(2)(iii) of this section, F will have its section 444 election terminated for subsequent years unless the tax deferral inherent in the structure is eliminated (*e.g.*, F1 is liquidated or the individual owners of F contribute their interest in F1 to F) prior to the date specified in paragraph (c)(4) of this section for subsequent taxable years beginning on or after February 1, 1988.

Example (18). The facts are the same as in example (16), except that F1 is 99 percent owned by F and none of the individual owners of F own any portion of F1. Furthermore, F obtained no tax benefit from creating and contributing assets to F1. Given these facts paragraph (c)(2)(iii) of this section does not apply and thus, F may make a section 444 election for its taxable year beginning February 1, 1987.

Example (19). G, a partnership with an October 31 taxable year, desires to retain its October 31 taxable year for its taxable year beginning November 1, 1987. However, as of December 31, 1987, G owns a 30 percent interest in G1, a calendar year partnership. G owns no other deferral entity, and G is 100 percent owned by calendar year individuals. Furthermore, G's interest in G1 does not meet the de minimis rule provided in paragraph (c)(3)(iii) of this section. Thus, in order to avoid being a tiered structure, G sells its interest in G1 to an unrelated third party prior to the date G timely makes it section 444 election for its taxable year beginning November 1, 1987. Although the sale of G1 allows G to qualify to make a section 444 election, and therefor to obtain a significant tax benefit, such benefit is not unintended. Thus, paragraph (c)(2)(iii) of this section does not apply, and G may make a section 444 election for its taxable year beginning November 1, 1987.

IV. Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Reporting of Interest Expense on Debt-Financed Acquisitions and Distributions Involving Passthrough Entities

Notice 88-37

I. BACKGROUND

In Notice 88-20, page 487, this Bulletin, the Internal Revenue Service provided temporary guidance with respect to the allocation of interest expense in connection with certain transactions involving partnerships and S corporations ("passthrough entities"). The transactions addressed in Notice 88-20 are (a) debt-financed contributions to the capital of and purchases of interests in passthrough entities ("debt-financed acquisitions") and (b) debt-financed distributions by passthrough entities to owners of such entities ("debt-financed distributions"). This notice provides guidance with respect to the reporting of interest expense in connection with such transactions.

II. EFFECTIVE DATES

This guidance applies to interest expense taken into account by owners of passthrough entities in taxable years beginning after December 31, 1986.

III. PERMISSIBLE ALTERNATIVES

Compliance with the reporting instructions set forth in this notice will facilitate the processing of returns of owners and passthrough entities. The Internal Revenue Service recognizes, however, that many taxpayers have filed their returns for taxable years beginning after December 31, 1986, and that Notice 88-20 is a recent pronouncement. Therefore, for taxable years beginning in 1987, reasonable alternative methods of reporting the interest expense described in this notice will be accepted regardless of whether the return was filed before or after this notice was issued. For example, the Service will accept a return on which interest expense properly reported on Schedule E under the rules in section IV of this notice is reported on Schedule A.

IV. INTEREST EXPENSE ON DEBT-FINANCED ACQUISITIONS

A. *Individuals*

1. *In general*

Individuals should report interest expense paid or incurred in connection with debt-financed acquisitions on either Schedule E or Schedule A of Form 1040, depending on the type of expenditure to which the interest expense is allocated. For purposes of this section IV, interest expense is allocated to a particular expenditure of a passthrough entity if the interest expense is allocated to such expenditure under the rules of §1.163-8T and Notice 88-20. (For purposes of this notice and Notice 88-20, the term "expenditure" has the same meaning as when used in §1.163-8T.) In addition, any interest expense allocated under the rules of Notice 88-20 to assets used in an activity shall be treated for purposes of this section IV in the same manner as interest expense allocated to an expenditure for such assets would be treated.

2. *Interest expense allocated to trade or business expenditures*

Interest expense allocated to a trade or business expenditure (within the meaning of §1.163-8T(b)(7)) of a passthrough entity should be reported in Part II of Schedule E. This interest expense should be identified on a separate line in column (a) as "business interest," followed by the name of the passthrough entity to which the interest expense relates, and the amount of such interest expense should be entered in column (h). This interest expense is deductible without limitation and should not be entered on Form 8582, relating to passive activity loss limitations, or Form 4952, relating to investment interest.

3. *Interest expense allocated to passive activity expenditures*

Interest expense allocated to a passive activity expenditure (within the meaning of §1.163-8T(b)(4)) of a passthrough entity should be entered on Form 8582 as a deduction from the activity in which such expenditure was made. The deductible amount (if any) of such interest expense, as determined under §1.469-1T(f)(2)(ii), should be reported in Part II of Schedule E. This interest expense should be identified on a separate line in column (a) as "passive interest," followed by the name of the passthrough entity to which the interest expense relates, and the amount of such interest expense should be entered in column (f).

4. *Interest expense allocated to investment expenditures*

Interest expense allocated to an investment expenditure (within the meaning of §1.163-8T(b)(3)) of a passthrough entity should be entered on Form 4952. The deductible amount (if any) of such interest expense should be reported on line 11 of Schedule A or on Schedule E in accordance with the instructions to Form 4952. See, however, the instructions to Form 1040 for circumstances in which deductible investment interest reportable on Schedule A may be reported on Schedule A without being entered on Form 4952. The investment interest that is reportable on Schedule E should be identified on a separate line in Part II, column (a), as "investment interest," followed by the name of the passthrough entity to which the interest expense relates, and the amount of such interest expense should be entered in column (h).

5. *Interest expense allocated to personal expenditures*

Interest expense allocated to a personal expenditure (within the meaning of §1.163-8T(b)(5)) made by a passthrough entity for or on behalf of the owner should be reported on line 12a of Schedule A.

B. *Other taxpayers*

Taxpayers other than individuals should report interest expense on debt-financed acquisitions on the line for interest expense on their returns. Although this interest expense need not be separately identified, it must be treated on the return in a manner that is consistent with the limitation (if any) that applies to such interest expense. Thus, for example, interest expense of a closely held C corporation (within the meaning of section 469(j)(1)) with respect to a debt-financed acquisition that is allocated to a portfolio expenditure (within the meaning of §1.163-8T(b)(6)) is not taken into account in computing net active income (within the meaning of section 469(e)(2)(B) and §1.469-1T(g)(4)(ii)).

V. INTEREST EXPENSE ON DEBT-FINANCED DISTRIBUTIONS

If, after the application of the rules in Notice 88-20, debt proceeds of a passthrough entity are allocated to distributions to owners of the entity, the portion of an owner's share of the passthrough entity's interest expense on debt proceeds allocated to distributions to owners that does not exceed the passthrough entity's interest expense on debt proceeds distributed to such owner should be included on the line on Schedule K-1 for other deductions. This interest expense should be identified on an attached schedule as "Interest expense allocate to debt-financed distributions." The passthrough entity should allocated a ratable portion of such interest expense to each distribution of debt proceeds to such owner and, on the attached schedule, should list all distributions to the owner to which debt proceeds are allocated and the amount of debt proceeds and interest expense allocated to each such distribution.

The manner in which the owner should report such interest expense depends on the types of expenditures that the owner makes with the distributed debt proceeds. Thus, for example, if the owner used the debt proceeds to make a personal expenditure (within the meaning of §1.163-8T(b)(5)), the owner should report the interest expense as personal interest on Schedule A.

Under Notice 88-20, if an owner's share of the passthrough entity's interest expense on debt proceeds allocated to distributions to owners exceeds the passthrough entity's interest expense on debt proceeds distributed to such owner, the passthrough entity may allocate the excess interest expense using any reasonable method. The interest expense allocated by the passthrough entity should be reported on Schedule K-1 in a manner consistent with such allocation. For example, if the passthrough entity allocates the excess interest expense to a rental activity, the expense should be taken into account by the entity in computing the income or loss from the rental activity that is reported to the owner on Schedule K-1.

Subject to certain restrictions, Notice 88-20 also permits the passthrough entity to allocate debt proceeds that are distributed to owners of a passthrough entity to expenditures other than distributions. The passthrough entity's interest expense on debt proceeds allocated to such other expenditures should be reported on Schedule K-1 in a manner consistent with such allocation. Thus, for example, if the passthrough entity allocates distributed debt proceeds to an expenditure in connection with a rental activity, the entity's interest expense on the debt proceeds should be taken into account by the entity in computing the income or loss from the rental activity that is reported to the owner on Schedule K-1.

Required Distributions from IRAs and Active Participant Status for 1987 Calendar Year

Notice 88-38

This notice provides individuals with an alternative method for satisfying the requirements for minimum distributions from individual retirement accounts and annuities (IRAs). This notice also provides a transition rule concerning active participant status for purposes of determining whether a deductible contribution to an IRA may be made.

REQUIRED DISTRIBUTIONS FROM IRAS

Section 408 of the Internal Revenue Code of 1986 (Code) requires individuals who attain age 70 1/2 to receive minimum distributions from their IRAs under rules similar to the rules of section 401(a)(9) of the Code. Section 1.408-8, A-1 of the proposed Income Tax Regulations (52 Fed. Reg. 28070 (1987)) provides that the IRA holder must satisfy the minimum distribution requirements separately for each IRA. Section 408 of the Code also requires beneficiaries of an IRA holder to receive minimum distributions after the death of the IRA holder. These regulations apply separately with respect to each IRA; thus, an individual may not reduce the minimum distribution required from one IRA even though he or she has received more than the minimum amount from another IRA.

Under the alternative method provided in this notice, individuals must still calculate the required minimum distribution separately for each IRA. However, such amounts may then be totalled and the total distribution taken from any one or more of the individual IRAs. Thus, contrary to the rule in the regulation, the alternative method would allow an individual to satisfy the minimum distribution requirement by taking from one IRA the amount required to satisfy the minimum distribution requirement for other IRAs. The alternative method is available to individuals who must receive minimum distributions either because they have attained age 70 1/2 or because they are beneficiaries of IRA holders who have died. For example, an individual who holds one IRA directly and another IRA as a beneficiary may satisfy the minimum distribution requirements by taking from the IRA held directly the amount required to satisfy the minimum distribution requirement for the IRA held as a beneficiary.

Section 1.403(b)-2 of the proposed Income Tax Regulations provides that, generally, for purposes of applying the minimum distribution requirements that are described in section 401(a)(9) of the Code, section 403(b) tax-sheltered annuity contracts will be treated as IRAs described in section 408 of the Code. Accordingly the alternative method described in this notice also applies to holders of section 403(b) annuity contracts or custodial accounts. Distributions from such 403(b) contracts or accounts, however, will not satisfy the distribution requirements from IRAs, nor will distributions from IRAs satisfy the distribution requirements from 403(b) contracts or accounts. The alternative method may not be used to satisfy the minimum distribution requirements applicable to qualified plans under section 401(a) or qualified annuity plans under section 403(a).

EXAMPLE

An individual (X), born July 15, 1916, has three IRAs. X became 70 1/2 on January 15, 1987. Thus, X's required beginning date is April 1, 1988. On December 31, 1986 the account balance of IRA A, a rollover IRA, was $100,000; the account balance of IRA B was $10,000; and the account balance of IRA C was $1,000. The designated beneficiary of IRA A is X's brother, whose age as of his birthday in 1987 was 61. The designated beneficiary of IRA B is X's spouse whose age as of his birthday in 1987 is 80. the designated beneficiary of IRA C is X's mother, whose age as of her birthday in 1987 is 90.

The amount of the minimum required distribution from IRA A is $3,952.57 ($100,000 divided by 25.3, the joint life and last survivor expectancy of X and X's brother). The amount of the minimum required distribution from IRA B is $588.24 ($10,000 divided by 17.0, the joint life and last survivor expectancy of X and her spouse). The amount of the minimum required distribution from IRA C is $63.29 ($1,000 divided by 15.8, the joint life and last survivor expectancy of X and her mother). The total required distribution that must be withdrawn from any one or more of X's accounts by April 1, 1988 is $4,604.10, the sum of the minimum required distributions from the three IRAs.

On April 1, 1988, X withdraws $1,000 from IRA C and $3,604.10 from IRA B. X withdraws nothing from IRA A. X has met her distribution requirements with respect to IRAs A, B, and C for the 1987 distribution calendar year. In determining the December 31, 1987 account balances used in calculating minimum required distributions for IRAs B and C for the 1988 distribution calendar year, the amount actually distributed from each IRA by April 1, 1988 is subtracted from the December 31, 1987 account balance of such IRA in accordance with the provisions of proposed regulation section 1.408-8, A-5.

APPLICABILITY OF ALTERNATIVE METHOD

The alternative method contained in this notice may be used until further guidance is issued. Such further guidance will be applied prospectively and will in no case limit use of the alternative method for minimum distributions required in 1988 (including distributions to be made by December 31, 1988).

TRANSITION RULE NOT AVAILABLE FOR DISTRIBUTIONS MADE AFTER DECEMBER 31, 1987

The proposed regulations under section 401(a)(9) and section 408 of the Code include a transition rule for satisfying the IRA minimum distribution requirements with respect to distributions made in 1987. IRA holders are reminded that such transition rule is no longer available for distributions made after December 31, 1987. Thus, individuals who attained age 70 1/2 in 1987 must determine the amount of the minimum distribution required by April 1, 1988 without regard to the transition rule. Similarly, the transition rule is not available for determining minimum distributions required by December 31, 1988 even by an individual who used the transition rule in 1987. Individuals adopting the alternative method contained in this notice for determining minimum required distributions should note that such method differs from the aggregate method in the 1987 transition rule.

ACTIVE PARTICIPANT STATUS FOR PRE-1987 ACTIVITIES

Section 219(g) of the Code limits deductions for contributions to IRAs by individuals who are active participants in certain plans. This rule is effective for taxable years of individuals which begin after December 31, 1986.

Notice 87-16, 1987-1 C.B. 446, provides the following rule for determining active participant status under a discretionary profit-sharing plan. If, with respect to a particular plan year, no forfeitures, employer contributions or employee contributions have been allocated to an individual's account by the last day of the plan year, such individual is not considered an active participant for the taxable year in which such plan year ends. If, however, after the end of such plan year, the employer contributes an amount for such plan year, an individual to whose account an allocation is made is considered an active participant for the taxable year in which the contribution is made.

A special rule for plan years beginning in 1986 and ending in 1987 is contained in Q & A 11 of Notice 87-16 for purposes of determining whether an individual is an active participant in 1987. Such plan year is treated as two short plan years, the first of which ends December 31, 1986. In addition, amounts allocated during the short 1987 plan year that are attributable to services performed in 1986 or to compensation that would have been paid (but for a deferral election) or was actually paid before January 1, 1987 because of activities in 1986 are treated as allocated on December 31, 1986. Thus, an individual is not an active participant in such a plan for 1987 if no amounts are allocated to his or her account for 1987 with respect to 1987 services or compensation.

A similar rule will apply to plan years of discretionary defined contribution plans ending on or before December 31, 1986. Thus, an individual will not be an active participant in 1987 solely because of amounts contributed or allocated in 1987 with respect to a plan year ending before January 1, 1987 if such contributions or allocations relate solely to services performed or to compensation that would have been paid (but for a deferral election) or was actually paid before January 1, 1987.

RELIANCE

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Required Distributions from Section 403(b) Arrangements

Notice 88-39

This notice allows a delay until December 31, 1988, of the required beginning date for minimum distributions from tax-sheltered arrangements described in section 403(b) of the Internal Revenue Code of 1986.

REQUIRED MINIMUM DISTRIBUTIONS

Section 1852(a)(3)(A) of the Tax Reform Act of 1986 (TRA'86), Pub. L. 99-514, 1986-3 (Vol. 1) C.B. 1, added to the Code section 403(b)(10), which applies minimum distribution requirements to tax-sheltered arrangements described in section 403(b) (including annuity contracts described in section 403(b)(1), custodial accounts described in section 403(b)(7) and retirement income accounts described in section 403(b)(9)). If the issuer or the custodian keeps the necessary records to identify the pre-1987 account balance, these requirements apply only to benefits which accrue under such tax-sheltered arrangement after December 31, 1986, including income on pre-January 1, 1987, accrued benefits.

Section 1.403(b)-2 of the proposed Income Tax Regulations provides that for purposes of applying the minimum distribution requirements of section 401(a)(9) of the Code, tax-sheltered arrangements will be treated as individual retirement annuities or individual retirement accounts described in section 408 of the Code.

Thus, in the case of distributions from a tax-sheltered arrangement, the required beginning date is April 1 of the calendar year following the calendar year in which the individual attains age 70 1/2. For employees who attained age 70 1/2 before January 1, 1988, the required beginning date is April 1 of the calendar year following the calendar year in which the employee retires. Absent this notice, the earliest required beginning date for any individual who attained age 70 1/2 in 1987 or earlier is April 1, 1988, and the minimum distribution for the 1987 distribution calendar year is based on the December 31, 1986, accrued benefit. The required beginning date under section 401(a)(9) of the Code is also the date which is relevant for determining, among other things, the designated beneficiary, the applicable after-death distribution requirements, and the recalculation of life expectancies.

Because the only benefits in a tax-sheltered arrangement that are subject to the distribution requirements are those accruing after December 31, 1986 (assuming the necessary records are maintained), in most cases the amount required to be distributed for the 1987 distribution calendar year with respect to such a section 403(b) tax-sheltered arrangement is zero.

Future regulations regarding section 403(b)(10) of the Code will provide that, in the case of any tax-sheltered arrangement from which no actual amount is required to be distributed on or before April 1, 1988, under section 403(b)(10) of the Code, the participant may treat December 31, 1988, as the required beginning date for all purposes under section 403(b)(10).

AFTER DEATH DISTRIBUTIONS

If an individual dies prior to January 1, 1987, a tax-sheltered arrangement must be distributed to the beneficiaries in accordance with section 401(a)(9)(B)(ii) or (iii) or (iv) of the Code, whichever is applicable. In order to satisfy these requirements, a distribution may be required to be made by December 31, 1987. However, because benefits that accrued before January 1, 1987, are not subject to the distribution requirements if appropriate records are kept, the amount required to be distributed by December 31, 1987, may be zero. A beneficiary who is not required to receive an actual distribution by December 31, 1987, may treat December 31, 1988, as the date of the first required distribution after death for purposes of determining the various rules that apply to after-death distributions.

RELIANCE

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Extension of Time to File for Taxpayers Traveling Outside of the United States and Puerto Rico

Notice 88-40

This notice provides guidance relating to the availability of the extension of time to file for taxpayers traveling outside the United States and Puerto Rico. The rules contained in this notice will be incorporated into regulations to be issued under section 6081 of the Internal Revenue Code of 1986. Those regulations will be effective March 28, 1988.

Section 1.6081-2(a) of the Income Tax Regulations provides an automatic two-month extension of time to file any income tax return and to pay the tax shown on that return in several circumstances. Section 1.6081-2(a)(5) provides such an extension for United States citizens residing or traveling outside the United States and Puerto Rico on the due date of the return. Section 1.6081-2(a)(6) provides such an extension for United States residents living or traveling outside the United States and Puerto Rico on the due date of the return. Both of these extensions apply to persons in military or naval service on duty outside the United States and Puerto Rico.

The rules with respect to United States citizens residing outside the United States and Puerto Rico and United States residents living outside the United States and Puerto Rico will remain in effect. However, the regulations governing automatic extensions for citizens or residents of the United States traveling outside the United States and Puerto Rico will be modified as follows. With respect to tax returns due on April 15, 1988, a taxpayer will be considered to be traveling outside the United States and Puerto Rico only if the period of travel outside the United States and Puerto Rico is a period of at least fourteen days continuous travel that includes all of April 15, 1988. For returns due after April 15, 1988, no such extension will be granted.

The automatic two-month extension of time for filing returns and paying any tax shown on that return will continue to be available to United States citizens or residents who are in military or naval service on duty outside the United States and Puerto Rico.

In no event will any extension of time to pay granted under section 1.6081-2(a) of the regulations prevent the imposition of interest on the amount of any underpayment of tax for the period beginning on the last date prescribed for payment, disregarding the extension, in accordance with section 6601(b) of the Code.

With respect to returns due on April 15, 1988, if the taxpayer claims an extension of time to file under section 1.6081-2(a)(5) or (6) of the regulations, and the taxpayer does not satisfy the requirements set forth above, the penalties provided by section 6651 of the Code for failure to file timely any return or to pay any tax shown due on that return shall apply unless the taxpayer establishes that such failure was due to reasonable cause and not due to willful neglect.

This document serves as an "administrative pronouncement" as that term is used in section 1.6661-3(b)(2) of the regulations and may be relied on to the same extent as a revenue ruling or revenue procedure. *See* Rev. Rul. 87-138, 1987-2 C.B. 287.

Court-Ordered Tax Increases

Notice 88-41

In September 1987, the United States District Court for the Western District of Missouri in the case of *Jenkins v. State of Missouri*, 672 F. Supp. 400 (W.D. Mo. 1987), approved a long-range capital improvement plan for the Kansas City, Missouri School District (KCMSD). To provide funding for the capital improvement plan, the court also ordered that (1) a 1.5 percent surtax be added to the Missouri State Income Tax on income earned within the KCMSD, and (2) the tax levy for the KCMSD be raised to $4 per $100 valuation.

Section 164(a) of the Internal Revenue Code, in general, allows a deduction for paid or accrued state and local income and property taxes. Section 164(b)(2) provides, in part, that a state or local tax includes only a tax imposed by a state or a political subdivision of the state.

The substance of the federal court's order was to direct the State of Missouri and the KCMSD to assess, levy, and collect these increased taxes. Thus, the requirement under section 164(b)(2) of the Code that the taxes be imposed by a state or political subdivision of the state is satisfied, and the state income tax surtax and the increased property tax levy are deductible taxes under section 164(a).

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or a revenue procedure. See Rev. Rul. 87-138, 1987-2 C.B. 287.

Notice on Alternatives to the Form W-4 Calculations for Withholding

Notice 88-42

In order to make the 1988 Form W-4, Employee's Withholding Allowance Certificate, as simple as possible, the Internal Revenue Service did not take into account on the form certain tax credits that would affect a relatively small number of people. The Service also simplified certain other calculations, thus resulting in a calculation that is less precise than would be possible in a more complicated form. This notice provides to employees instructions that they may follow to match their withholding more closely to their expected tax liability.

BACKGROUND

An employee completes the Form W-4 to determine the number of withholding allowances (or exemptions) that he or she is entitled to claim.

WITHHOLDING ALLOWANCES AND TAX CREDITS

Employees are permitted by Service regulations to take into account tax credits to which they are entitled in determining the total number of withholding allowances. An adjustment to withholding for the child and dependent care credit under section 21 of the Internal Revenue Code is provided in the 1988 Form W-4, and the employee can elect to receive advance payment of the earned income credit under section 32 by filing Form W-5, Earned Income Advance Payment Certificate, with the employer. In addition, although not mentioned on the 1988 Form W-4, an employee may at his or her option take the following credits into account in determining the number of withholding allowances to which he or she is entitled: (1) the credit for the elderly and the permanently and totally disabled under section 22; (2) the credit on certain home mortgages under section 25; (3) the foreign tax credit under section 27 (but see below); (4) the earned income credit under section 32, provided the employee has not filed for the advance payment of the credit on Form W-5; and (5) the general business credit under section 38.

In determining the number of withholding allowances an employee may claim for the tax credits listed above, an employee should first determine the total estimated dollar amount of the tax credits available for 1988 based on tax credits for previous years and any new circumstances that may give rise to additional credits for 1988.

Generally, employees may include the foreign tax credit available under section 27 in calculating withholding allowances under this notice. However, if compensation is excluded from United States income tax withholding because it is subject to income tax withholding by a foreign country, the foreign tax credit attributable to that compensation should not be included in total credits for purposes of calculating withholding allowances.

After the total dollar amount of the tax credits available for 1988 has been determined, an employee should multiply that dollar amount by the appropriate number determined from the table below. The amount resulting from the multiplication mentioned in the preceding sentence should then be added to the amount otherwise includible on line 5 of the "Deductions and Adjustments Worksheet" on page 2 of the 1988 Form W-4. An employee who wishes to take these credits into account should use the Deductions Worksheet for this purpose even though he or she would not otherwise use it.

If an employee who expects to take the child and dependent care credit wishes to use this method of calculating his withholding allowances rather than using line F of 1988 Form W-4 he or she may do so.

Married Filing Jointly or Qualifying Widow(er)		Single or Married Filing Separately		Head of Household	
If combined estimated wages are	Multiply credits by	If estimated wages are—	Multiply credits by	If estimated wages are—	Multiply credits by
$0 to 41,000	6.7	$0 to 23,000	6.7	$0 to 32,000	6.7
41,001 to 83,000	3.6	23,001 to 48,000	3.6	32,001 to 70,000	3.6
over 83,000	3.0	over 48,000	3.0	over 70,000	3.0

ALTERNATIVE METHOD OF CALCULATING WITHHOLDING ALLOWANCES

Employees are permitted by Service regulations to take most items of income, adjustments to income, deductions, and tax credits into account in determining their proper number of withholding allowances. However, because the 1988 Form W-4 provides a simplified manner for taking these items into account, use of the Form W-4 does not always provide taxpayers with withholding results that precisely match their tax liabilities.

Taxpayers are not required to use the Form W-4 calculation of the proper number of withholding allowances if they use a more accurate method that takes into account only the items of income, adjustments to income, deductions, and tax credits referred to on Form W-4 and its instructions and other tax credits, and if they base their calculation on withholding schedules, tax rate schedules, and the Form 1040ES worksheet. The number of withholding allowances determined under this alternative method may be used in lieu of the number of allowances reached by following the Form W-4 computations.

ADMINISTRATIVE PRONOUNCEMENT

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Nonconventional Source Fuel Credit

Notice 88-43

ACTION: Publication of inflation adjustment factor and reference price for calendar year 1987 as required by section 29(d)(2)(A) of the Internal Revenue Code (26 U.S.C. section 29(d)(2)(A) (formerly section 44D, renumbered by the Deficit Reduction Act of 1984).

SUMMARY: The inflation adjustment factor and reference price are used in determining the availability of the tax credit for production of fuel from nonconventional sources under section 29 of the Internal Revenue Code.

DATE: The 1987 inflation adjustment factor and reference price apply to qualified fuels sold during calendar year 1987.

INFLATION FACTOR: The inflation adjustment factor for calendar year 1987 is 1.4949.

PRICE: The reference price for all qualified fuels is $15.41 per equivalent barrel for the 1987 calendar year.

Because the above reference price does not exceed $23.50 multiplied by the inflation adjustment factor, the phaseout of credit provided for in section 29(b)(1) of the Internal Revenue Code does not occur for any qualified fuel based on the above reference price.

D. Kevin Dolan,
Associate Chief Counsel
(Technical and
International).

(Filed by the Office of the Federal Register on March 11, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 14, 1988, 53 F.R. 8295)

Application of Floor Stocks Tax on Diesel and Aviation Fuel Held on April 1, 1988

Notice 88-44

The purpose of this notice is to provide guidance to taxpayers relating to the floor stocks tax imposed by section 10502(f) of the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203, 101 Stat. 1330) ("1987 Act") on taxable fuel held by a taxable person on April 1, 1988. See also Notice 88-30, page 497, this Bulletin, and Announcement 88-64, 1988-16 I.R.B. 35.

Section 10502(f) of the 1987 Act imposes a floor stocks tax on any taxable fuel held by a taxable person on April 1, 1988, at the rate of tax which would be imposed if such fuel were sold on such date in a sale subject to tax under section 4091 of the Internal Revenue Code ("Code"). Section 10502(f)(3) of the 1987 Act provides that the taxes imposed by section 10502(f) shall be paid before June 16, 1988.

A "taxable person" is defined in section 10502(f)(4)(B) of the 1987 Act as any person other than a producer (as defined in section 4092 of the Code) or importer of taxable fuel. Section 10502(f)(4)(A)(i) defines "taxable fuel" as any taxable fuel (as defined in section 4092 of the Code) on which no tax has been imposed under section 4041 of the Code. Section 10502(f)(4)(A)(ii) provides, however, that the term "taxable fuel" shall not include fuel held exclusively for any use which is a nontaxable use (as defined in section 6427(1) of the Code). Thus, a person must pay a floor stocks tax only if such person is a taxable person and holds taxable fuel on April 1, 1988.

A person must satisfy both prongs of this test before the tax will apply. A person is a taxable person if such person is not a producer (as defined in section 4092(b)) or importer of diesel or aviation fuel. See also Notice 88-30. A liquid is taxable fuel for purposes of the floor stocks tax only if all three of the following apply—

(1) The liquid is a liquid other than gasoline which is suitable for use as a fuel in a diesel-powered highway vehicle or in an aircraft,

(2) The liquid was acquired prior to April 1, 1988, in a sale not subject to tax under section 4041, and

(3) The liquid is not held exclusively for a nontaxable use as defined in section 6427(1) of the Code. (That is, diesel or aviation fuel held for a taxable use is subject to the floor stocks tax, and fuel held exclusively for a nontaxable use is not subject to the floor stocks tax.)

The Internal Revenue Service will consider fuel held for a nontaxable use to be held exclusively for a nontaxable use (and therefore not subject to the floor stocks tax) as follows—

(a) If fuel is held in a storage facility that contains only fuel intended for a nontaxable use, the Internal Revenue Service will consider all fuel in the storage facility to be held exclusively for nontaxable use.

(b) If fuel is held in a storage facility that holds both fuel intended for a taxable use and fuel intended for a nontaxable use (i.e. "mixed storage"), the Internal Revenue Service will consider the amount or percentage of such fuel intended for a nontaxable use to be held exclusively for a nontaxable use.

If a taxable person maintains diesel or aviation fuel in mixed storage on April 1, 1988, such person must determine the amount or percentage of such fuel intended for a nontaxable use by the date payment of the floor stocks tax is due. This determination is made on a first-in, first-out basis. If all fuel held in mixed storage on April 1, 1988, has been used by the date payment of the floor stocks tax is due, such determination shall be made based on actual usage.

If all fuel held in mixed storage on April 1, 1988, is not used by the date payment of the floor stocks tax is due, such determination shall be made based on the amount of such fuel actually used for a nontaxable purpose, together with a reasonable estimate of such person's anticipated use of all such fuel not used by the date payment of the floor stocks tax is due. An estimate generally will be considered to be reasonable if it is based on such person's past usage of diesel or aviation fuel. However, if, when the fuel is actually used, the amount of fuel actually used for a nontaxable use is less than the amount of fuel estimated to be held for a nontaxable use, such taxable person must pay the additional tax due and file an amended return reflecting the proper amount of taxable fuel held on April 1, 1988, by the date prescribed for the filing of a Form 720 for the quarter in which the fuel is actually used. See also section 10502(f)(2) of the 1987 Act and section VI(E)(4) of Notice 88-30 relating to a credit or refund for overpayment of the floor stocks tax.

The provisions of this notice may be illustrated by the following examples:

Example 1: A producer or importer holds diesel fuel on April 1, 1988, on which no tax was imposed under section 4041. The producer or importer is not a taxable person and the floor stocks tax does not apply.

Example 2: At the first moment of April 1, 1988, a fuel retailer holds diesel fuel on which no tax was imposed under section 4041. All of the fuel is held for sale to users. The retailer is a taxable person holding taxable fuel. The floor stocks tax applies to the retailer's entire inventory.

Example 3: At the first moment of April 1, 1988, a farmer holds diesel fuel in mixed storage on which no tax was imposed under section 4041. All of the fuel is not used by the date payment of the floor stocks tax is due. Based on actual usage until such date and past practice with respect to usage of diesel fuel, the farmer determines that 90% of the diesel fuel held in inventory on April 1, 1988, is held exclusively for a nontaxable use and that 10% of such fuel is held for a taxable use. The farmer is a taxable person and 10% of the fuel held on April 1, 1988, is taxable fuel. The floor stocks tax applies to 10% of the fuel held in the farmer's inventory on April 1, 1988.

The floor stocks tax imposed by section 10502(f) of the 1987 Act is reported on Form 720, "Quarterly Federal Excise Tax Return". The floor stocks tax applies only to the number of gallons of taxable fuel held in inventory on April 1, 1988, as determined under the rules of this notice and Notice 88-30. Fuel held exclusively for a nontaxable use as determined under the rules of this notice is not taxable fuel for purposes of the floor stocks tax, and the floor stocks tax should not be reported with respect to this fuel on Form 720. See also section VI of Notice 88-30 regarding the inventory required to be taken on April 1, 1988.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3 (b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Taxable Year of Trusts—Income Received by Certain Beneficiaries May Be Spread Over 4 Years

Notice 88-45

Under section 645 of the Internal Revenue Code of 1986 (the Code), all trusts are required to use the calendar year as their taxable year. As a result of this requirement trusts that previously were fiscal year taxpayers had short taxable years in 1987. In order to prevent beneficiaries of such trusts from including income from two trust tax years in their income for 1987, section 1403(c)(2) of the Tax Reform Act of 1986 (the Act) provides that such beneficiaries must spread their income attributable to the trust's short year ratably over a four year period beginning with the beneficiaries' 1987 tax year. This four year reporting requirement is mandatory. There is a pending technical correction that would allow any trust beneficiary to elect to waive the benefits of the four year spread. Additional guidance will be provided to taxpayers if this technical correction is enacted.

Where a beneficiary who is subject to section 1403(c)(2) of the Act dies prior to the end of the four year period, any remaining unreported income shall be included in gross income for the beneficiary's last taxable year. Taxpayers are reminded that amounts paid in satisfaction of a decedent's final income tax liability are deductible for Federal estate tax purposes under section 2053 of the Code.

Section 1403(c)(3) of the Act applies only to amounts that beneficiaries are required to include in income under section 652(a) or 662(a) of the Code. Thus, the four year spread rule does not apply to the beneficiaries of charitable remainder trusts (as defined in section 664(d) of the Code), and beneficiaries of such trusts must report the entire amount received from such trusts as received in their current taxable year. There is a pending technical correction to the Act that would make the four year spread rule available to the beneficiaries of charitable remainder trusts. Additional guidance will be provided to taxpayers if this technical correction is enacted.

This document serves as an "administrative pronouncement" as that term is described in §1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Leaking Underground Storage Tank Trust Fund

Notice 88-46

The purpose of this Notice is to clarify that a claim filed under section 6421 of the Code for a credit or refund by certain ultimate purchasers of gasoline includes the amount attributable to the Leaking Underground Storage Tank Trust Fund financing rate ("LUST rate").

The ultimate purchasers referred to in the preceding sentence include persons using gasoline: (1) in a vessel employed in the fisheries or in the whaling business (*see* section 6421(a), relating to nonhighway use); (2) in intercity, local, or school buses (*see* section 6421(b)); and (3) for any purpose described in section 4221(a)(2) (relating to exportation), (a)(3) (relating to vessel or aircraft supplies), (a)(4) (relating to State or local government use), or (a)(5) (relating to nonprofit education use) (*see* section 6421(c), relating to use for certain exempt purposes).

Therefore, notwithstanding the provisions to the contrary in the proposed regulations published in the Federal Register on November 18, 1987 (52 FR 44141) ("proposed regulations"), the credit or refund under section 6421 to such an ultimate purchaser (for example, a State or local government) is an amount equal to the product of the number of gallons of gasoline purchased (in the case of a credit or refund allowed under section 6421(c)), or used (in the case of a credit or refund allowed under subsection (a) or (b) of section 6421), multiplied by the rate at which tax was imposed on the gasoline under section 4081, including the amount attributable to the LUST rate.

The proposed regulations do not amend the credit or refund procedures under section 6420 of the Code, relating to gasoline used on a farm, since the procedures under section 6420 were not amended by the Tax Reform Act of 1986. A credit or refund under section 6420 includes the amount attributable to the LUST rate.

The credit or refund allowed under section 6421(a) with respect to gasoline used in an off-highway business use other than use in a vessel employed in the fisheries or in the whaling business does not include the amount attributable to the LUST rate. *See* section 6421(f)(4) of the Code. However, Congress is considering a Technical Corrections Bill that would amend section 6421(f), as it relates to the credit or refund amount attributable to the LUST rate for certain nonhighway use under section 6421(a). If the technical correction is enacted, further guidance will be provided.

The clarification provided by this Notice will be reflected in the final regulations.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3 (b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Foreign Tax Credit for Panamanian Taxes

Notice 88-47

Sections 901 and 902 of the Internal Revenue Code of 1986 allow United States taxpayers a credit against their federal income tax liability for certain taxes that they and their subsidiaries pay to any foreign country. On March 25, 1988, President Eric Arturo Delvalle of Panama, exercising powers granted him by the Constitution of Panama, issued Executive Decree No. 16, directing that income taxes due to the Government of Panama be paid to the order of the Government of the Republic of Panama in the Federal Reserve Bank of New York, through the Embassy of Panama in Washington as collection office. On March 31, 1988, the Embassy of Panama in Washington issued a supplemental decree providing a method for paying such taxes and specifying Government of Panama Account Number 2 at the Federal Reserve Bank in New York as the account into which the taxes should be paid. This notice confirms that income taxes due to the Government of Panama which are paid into such account will be considered paid to the Government of Panama, and will therefore be creditable foreign taxes if all other requirements of sections 901 and 902 of the Code are satisfied.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3 (b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Copies of the supplemental decree, and of an unofficial translation of Executive Decree No. 16, are reproduced below.

[UNOFFICIAL TRANSLATION]

EXECUTIVE DECREE NO. 16 OF THE 25TH OF MARCH 1988

In which is decreed an extension of the period of time for filing of income tax returns and for payment of the corresponding adjusted tax and of other tributary obligations.

THE PRESIDENT OF THE REPUBLIC

Within his legal capacity,

CONSIDERING;

1. that the current political, economic and financial conditions of the Republic of Panama prevent taxpayers from fulfilling their tributary obligations under the law;

2. also that governmental institutions of the country are headed by persons not authorized by the Constitutional Government of the Republic;

3. that Article 710 of the Fiscal Code establishes that taxpayers must, no later than the 31st of March, file their sworn income tax return for the previous taxable year and pay the adjusted tax calculated using the payment indicated in the sworn tax return relative to the estimated as owed for the same year;

4. that, under Section 5 of Article 179 of the constitution, the Executive branch has the role of "overseeing the collection and administration of national taxes";

5. that the Executive branch cannot permit that taxes, duties, revenues and other national income be collected and used by an illegitimate government that, only because of the sole will of a dismissed soldier, maintains public power in the absence of popular will; and

6. that, given the above, it is necessary to authorize an extension of the period of time for filing income tax returns and for paying corresponding adjusted tax, as well as a suspension in favor of all taxpayers with respect to other tributary obligations.

DECREES:

Article I: The period for filing a sworn income tax return for the 1987 fiscal period and for paying the adjusted tax calculated from the sworn declaration and the estimated declaration for said fiscal period is hereby extended until the 30th of April of 1988.

Article II: Until Constitutional order has been restored, any income tax payment and, particularly any payment of the adjusted tax described in Article 710 of the fiscal code, which is made in a manner different from that described in the present Decree shall not be deemed as good payment.

Article III: Until the executive branch provides otherwise, fiscal obligations discussed in this Decree may be paid only through deposits made to the order of the Government of the Republic of Panama in the Federal Reserve Bank of New York.

The deposit voucher which is made in conformity with the above provision will serve as a valid receipt for credit of payment of fiscal obligations to which this Decree makes reference.

Article IV: For purposes of filing income tax returns, the Embassy of Panama in the United States of America will serve as the collection office.

Article V: An indefinite suspension in favor of all State taxpayers is hereby decreed with respect to all fiscal obligations other than the income tax adjustment. As a result, during the time in which this suspension is in force, said taxpayers are exempt from the fulfillment of all tributary obligations consigned under the law.

During the effectiveness of this suspension, the failure to pay a tributary obligations will not create interest, fiscal penalties nor other charges.

Article VI: This Decree will become effective upon its enactments and it will be published through available means.

COMMUNICATED AND
PUBLISHED,

/s/
Eric A. Delvalle
President of the
Republic

/s/
Ramon De Alba O.
Ministry of Treasury
and Finance

DECREE

Eric Arturo Delvalle, President of the Republic of Panama, in the lawful exercise of his powers under the Constitution, hereby decrees:

Acting in the best interests of the Republic of Panama, I hereby amplify Executive Decree Number 16 of March 25, 1988, which provides that all income taxes owed to the Republic of Panama may be paid only through deposits made to the order of the Government of the Republic of Panama in the Federal Reserve Bank of New York, and hereby decree that all such payments are to be made to the order of Government of Panama Account Number 2 at said Bank, which account has been opened for the express and sole purpose of receiving tax payments.

Executed on the 31st of March, 1988.

Juan B. Sosa
Legal Representative in
the United States of
America of the
Republic of Panama,
Ambassador of the
Republic of Panama
to the United States
of America

Penalty for Failure by Income Tax Return Preparer to Sign Return

Notice 88-48

It has come to the attention of the Internal Revenue Service that the enactment of new section 645 of the Internal Revenue Code which is effective for taxable years beginning after December 31, 1986, may result in the imposition of special hardships on preparers of Forms 1041, U.S. Fiduciary Income Tax Returns. Section 645 of the Code, added by section 1403(a) of the Tax Reform Act of 1986, requires trusts, with certain limited exceptions, to use a calendar taxable year. Section 6695(b) of the Code provides that income tax return preparers who are required by regulations to sign returns or claims for refund prepared by them and fail to do so, shall pay a penalty of $25.00 for each such failure unless the failure is due to reasonable cause. Section 1.6695-1(b)(1) of the Income Tax Regulations generally provides that, income tax return preparers must manually sign returns or claims for refund prepared by them. Thus, most Forms 1041 must now be filed by April 15, plus extensions, and the requirement to manually sign each return at that time creates hardships for income tax return preparers responsible for the preparation of large numbers of such returns.

In order to alleviate these hardships, the Service will not assert against a preparer of 1987 Forms 1041 the section 6695(b) penalty for failure to sign a return provided the preparer uses a facsimile signature in signing the returns and meets the following conditions:

(1) the preparer submits to the Service with the Forms 1041 bearing the preparer's facsimile signature, a letter manually signed by the preparer (a) listing the taxpayer name and identification number shown on each Form 1041 bearing the facsimile signature, and (b) containing a declaration, under penalties of perjury, that the facsimile signature appearing on each return is the signature used by the preparer to sign the return;

(2) after the facsimile signature is affixed, no person other than the preparer may alter any entries on the Form 1041 other than to correct arithmetical errors discernible on the return; and

(3)(a) the employer of the preparer, or (b) the partnership in which the preparer is a member or (c) the preparer (if neither (a) nor (b) applies), retains and makes available, upon request by the Service, a manually signed copy of the letter submitted to the Service with the returns and a record of any arithmetical errors corrected.

The Service will consider amending the regulations under section 6695(b) of the Code to permit the use of facsimile signatures by preparers of Forms 1041.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure. See Rev. Rul. 87-138, 1987-2 C.B. 287.

Partnerships and S Corporations—Section 444 Election

Notice 88-49

Significant guidance has been provided relating to sections 444, 7519 and 280H, including Notice 88-10, page 478, this Bulletin, regarding certain issues of immediate concern, Announcement 88-49, providing guidance to certain corporations electing S status, and Notice 88-36 providing guidance regarding the definition of a tiered structure. Nevertheless, there is some uncertainty remaining under present law because comprehensive temporary regulations regarding these sections have not yet been issued by the Office of the Commissioner of the Internal Revenue Service, the Office of Chief Counsel, and the Treasury Department Office of Tax Policy. This notice attempts to reduce th remaining uncertainty by: (1) waiving certain penalties that would otherwise be imposed on owners (of partnerships and S corporations considering a section 444 election) who must take certain actions (e.g., request an extension of their 1987 income tax return) by April 15, 1988; and (2) answering the most common and important unanswered questions regarding these sections, thus enabling most partnerships and S corporations to decide whether they will make a section 444 election when regulations and the election form are issued. Comprehensive temporary regulations interpreting sections 444, 7519 and 280H will be issued in the very near future.

I. *Background.*

Section 444 of the Internal Revenue Code, added by section 10206 of the Omnibus Budget Reconciliation Act of 1987 (Pub. L. 100-203, 101 Stat. 1330), was enacted into law on December 22, 1987. Section 444 of the Code allows certain partnerships, S corporations, and personal service corporations to elect the use of a taxable year that is different from the taxable year that such entities would otherwise be required to use. On January 15, 1988, the Internal Revenue Service issued Notice 88-10 (page 478, this Bulletin) to provide guidance with respect to certain issues of immediate concern to taxpayers affected by section 444. Notice 88-10 explained that forthcoming temporary regulations would provide that a section 444 election shall not be required to be made before the later of (i) April 30, 1988, or (ii) 60 days after the publication of those temporary regulations in the Federal Register. This Notice 88-49 does not constitute the publication of temporary regulations in the Federal Register, and this Notice 88-49 does not commence the beginning of the 60-day period for making a section 444 election.

Furthermore, on March 11, 1988, the Internal Revenue Service issued Announcement 88-49 (1988-13 I.R.B. 34) to provide guidance to corporations electing S status that may consider making a section 444 election. Finally, on March 15, 1988, the Internal Revenue Service issued Notice 88-36 (page 517, this Bulletin) to provide guidance regarding the definition of a "tiered structure" for purposes of section 444(d)(3).

Although comprehensive temporary regulations on sections 444, 7519 and 280H will soon be issued, the Internal Revenue Service is aware that taxpayers are in need of immediate guidance on several issues. The issues arise because of uncertainties surrounding the ability of various entities to make a section 444 election for their taxable year beginning in 1987 and the resulting uncertainties created for owners of such entities in filing their 1987 Federal income tax returns.

For example, assume I, a calendar year individual, owns an interest in P, a profitable partnership that previously had a September 30 taxable year. Furthermore, assume that pending publication of comprehensive temporary regulations on sections 444, 7519, and 280H, P is uncertain whether it will make a section 444 election. If P does not make a section 444 election, P will be required to have a short taxable year for the period October 1 to December 31, 1987. Given these facts, I is uncertain as to how much taxable income from P to include on his 1987 tax return (or application for extension of time to file a return) that is due April 15, 1988. If I assumes that P is going to make a section 444 election, but P ultimately does not make a section 444 election, I is concerned that I could be subject to a (A) penalty for failure to pay tax on a timely basis; (B) penalty for failure to file a timely return (*i.e.*, if I files an extension request for I's 1987 return and such extension request is invalidated for failure to make an accurate estimate of 1987 tax); (C) penalty for underpaying I's 1988 estimated tax payment due April 15, 1988 (*e.g.*, if I bases such payment on I's estimated 1987 tax liability); and (D) liability for payment of interest on any underpayment of tax.

II. *Summary of Guidance.*

Section III of this notice provides guidance on several administrative issues (*e.g.*, time for filing returns, waiver of penalties, and the imposition of interest) of immediate concern to owners of a partnership or S corporation that is considering whether to make a section 444 election. Section IV of this notice provides guidance on several substantive issues that are of immediate concern to partnerships and S corporations contemplating a section 444 election.

III. *Administrative Issues.*

A. *Background.*

Section XI of Notice 88-10 provided that the temporary regulations would extend the time for filing a tax return of a partnership, S corporation, or personal service corporation that makes (or decides not to make) a section 444 election for its first taxable year beginning in 1987. Notice 88-10 did not, however, extend the time for filing the tax returns, or the time for payment of income tax, of the owners of a partnership or S corporation that is undecided about whether it should make a section 444 election. Thus, taxpayers are reminded that an extension of time to file a partnership return or an S corporation income tax return does not extend the time for filing the income tax return of the partners or shareholders.

B. *Waiver of certain penalties for owners of a partnership or S corporation considering whether to make a section 444 election.*

If an owner of a partnership or S corporation is assessed a penalty under section 6651(a)(2) for failure to pay income tax or a penalty under section 6654 for underpayment of its first quarter 1988 estimated tax payment, the Internal Revenue Service will waive the portion of such penalty that is attributable to section 444. In addition, the Internal Revenue Service has received several questions on whether an owner (of a partnership or S corporation) who has timely filed a request for extension of time to file the owner's 1987 tax return could be assessed a penalty under section 6651(a)(1) (for failure to timely file an income tax return) because insufficient tax was paid with the request for extension. Such owners will not be subject to a penalty for failure to file, because the Internal Revenue Service generally does not assess a penalty for failure to file upon invalidation of a request for extension.

The portion of the penalty attributable to section 444 is an amount equal to the difference between what the penalty would be assuming a section 444 election is made and what the penalty would be assuming a section 444 election is not made. However, the penalty waiver only applies to that portion of the penalty that is attributable to an underpayment from the due date through August 15, 1988. See section III. D. of this notice for an example.

Taxpayers should be aware that the Internal Revenue Service will be unable to identify those eligible for this waiver of penalty prior to assessment of the penalty. Accordingly, in order to obtain consideration of a waiver, taxpayers will need to return their penalty notice to the Internal Revenue Service with an explanation that they are eligible for a penalty waiver under Section III. B. of Notice 88-49, including identification of the partnership(s) or S corporation(s) (or both) and the portion of the penalty attributable to each such entity.

Accordingly, partnerships and S corporations that have already decided whether they will make a section 444 election are encouraged to furnish their owners with the information necessary to timely file their return (or compute the tax that would otherwise be due with an application for extension of time for filing) and pay their tax so that such owners may avoid receiving a penalty notice.

C. *Interest on late payment of tax.*

Under section 6601 of the Code, interest must be paid on any underpayment of income tax beginning with the due date (determined without regard to any extension of time for payment) of the tax. Thus, although Section III. B. of this notice waives certain penalties for the late payment of income tax, notwithstanding such waiver interest will be imposed as provided in section 6601 with respect to any such late payment.

D. *Example.*

The following example demonstrates the provisions of section III of this notice.

Assume HW, a husband and wife that file a joint return on a calendar year basis, own an interest in P, a partnership. P has historically used a June 30 taxable year and as of April 15, 1988 is undecided whether it is going to make a section 444 election to retain a year ending June 30 for its taxable year beginning July 1, 1987. HW's 1987 income tax liability will be $20,000 if P makes a section 444 election and $25,000 if P does not make a section 444 election. Further, assume that on or before April 15, 1988 HW file Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return, to extend their 1987 income tax return and make a tax payment with such extension request in an amount sufficient to bring their total payments for the year to $20,000. However, on July 1, 1988 HW are informed that P did not make a section 444 election. Thus, when HW file their 1987 income tax return on August 15, 1988, they pay an additional $5,000 of tax.

Absent the relief provided in this notice, HW would, under section 6651(a)(2), be subject to a penalty for failure to pay tax and, in addition, HW could, under section 6651(a)(1), be subject to a penalty for failure to file a timely return if their extension request is invalidated.

Pursuant to this notice, the Internal Revenue Service will waive such penalties, if assessed, because they are attributable to section 444. However, the Internal Revenue Service will not waive any interest on the $5,000 underpayment of tax. Furthermore, the Internal Revenue Service will waive that portion of any penalty for underpayment of HW's first quarter 1988 estimated tax that is attributable to section 444.

IV. *Substantive issues.*

A. *New entity electing to be an S corporation.*

The Internal Revenue Service has received a number of inquiries concerning two issues related to newly formed corporations that elected to be S corporations. The first issue is whether a newly formed corporation that elected to be an S corporation for its first taxable year beginning in 1986 and ending on December 31, 1986, may, pursuant to section 444(b)(2), change to a fiscal year for its taxable year beginning January 1, 1987.

Forthcoming temporary regulations will provide that an S corporation whose first taxable year ended on December 31, 1986 may not make a section 444 election and change to a fiscal year, because under section 444(b)(2), the deferral period of the taxable year being changed is zero. Moreover, the special rule under section 10206(d)(4) of the 1987 Act for existing entities electing S status does not apply to such an S corporation, because the corporation was never a C corporation before making its S election.

The second issue concerns a newly formed corporation that elected to be an S corporation for its first taxable year beginning in 1987. Specifically, if, as a condition for making its S election, such corporation agreed to use a calendar year, the issue is whether such corporation may make a section 444 election for its first taxable year beginning in 1987. Forthcoming temporary regulations will provide that the prior agreement to use a calendar year may be disregarded and thus such corporation may make a section 444 election for its first taxable year beginning in 1987.

B. *"Applicable percentage" for first taxable year beginning in 1987.*

Under section 806(e)(2)(C) of the Tax Reform Act of 1986, (the 1986 Act), certain partners and shareholders are entitled to a four-year "spread" on the excess of their share of income over expenses from a partnership or S corporation that is required to change its taxable year under the 1986 Act. In order to provide a de facto four-year spread, section 7519(b)(2) of the Code multiplies the required payment otherwise required to be made by a partnership or S corporation by the applicable percentage defined in section 7519(d)(4). However, certain entities (e.g., a corporation that elected to be an S corporation for a taxable year beginning in 1987) that may qualify to make a section 444 election, and thereby obtain the de facto four-year spread, have partners or shareholders that would not have been entitled to the four-year spread under section 806(e)(2)(C) of the 1986 Act. As a result, the Internal Revenue Service has received several inquiries concerning whether the applicable percentage for taxable years beginning in 1987 for such entities will be changed from 25 percent to 100 percent.

Forthcoming temporary regulations will provide that the applicable percentage for the first taxable year beginning in 1987 of any taxpayer properly making a section 444 election will be 25 percent.

C. *Entities liquidated or sold for tax purposes prior to making a section 444 election.*

If a partnership, S corporation, or personal service corporation is liquidated or sold before making a section 444 election for a particular taxable year, it is unclear whether a section 444 election may be made for such taxable year. If the election may not be made, the taxpayer will be required to change its taxable year to its required year, which may result in two consecutive short period returns.

For example, assume an existing S corporation historically used a June 30 taxable year and desires to retain such year for its taxable year beginning July 1, 1987 by making a section 444 election. However, the S corporation is liquidated for tax purposes on February 15, 1988. The issue is whether such S corporation may, if otherwise qualified, make a section 444 election even though it is no longer in existence for tax purposes. If a section 444 election can be made, the S corporation will file its final income tax return for the period July 1, 1987 to February 15, 1988. If a section 444 election cannot be made, the S corporation will be required to file two short period income tax returns: July 1 to December 31, 1987 and January 1 to February 15, 1988.

Forthcoming temporary regulations will provide that a taxpayer is not precluded from making a section 444 election merely because the taxpayer is liquidated or sold for tax purposes before a section 444 election is made for the year. However, it should be noted that if the provisions of section 7519 apply in such a situation, the taxpayer must make the required payment under section 7519 and subsequently apply for a refund of such payment in accordance with the forthcoming temporary regulations.

D. *Can required payments effectively be computed on the same income in the case of a tiered structure?*

The Internal Revenue Service has received several questions concerning how required payments should be calculated for members of a tiered structure. Specifically, taxpayers are concerned that two or more required payments may effectively be computed on the same taxable income.

Forthcoming temporary regulations will provide that a partnership or S corporation that has made a section 444 election must separately determine the amount of its required payment without regard to the required payment of any other member of the tiered structure. Thus, in certain cases the same taxable income could be subject to more than one required payment. However, the forthcoming temporary regulations will minimize this possibility by providing that a taxable year elected under section 444 by a particular entity will be used for purposes of determining the taxable year under section 706(b) of any partnership owned by the electing entity.

For example, assume partnership A desires to retain its June 30 taxable year by making a section 444 election. Further, assume that A has owned for several years 99 percent of the profits and capital in B, a partnership also desiring to retain its June 30 taxable year. If both A and B are required to make section 444 elections, B's taxable income would be effectively subject to two required payments. However, the forthcoming temporary regulations will provide that if A makes a section 444 election to retain its June 30 taxable year, then B's required year pursuant to section 706(b)(2)(B) shall be June 30, since B's majority partner has a June 30 taxable year. Thus, in such a situation, B may retain its June 30 taxable year without making a section 444 election.

E. *Refunds of required payments.*

Section IX of Notice 88-10 provides substantial guidance with respect to refunds of required payments, including discussion of various events that will entitle a taxpayer to a refund. However, taxpayers are uncertain when these refunds will be made.

Procedures will be established to pay refunds on a timely basis. However, in no event shall a refund be made prior to April 15 of the second calendar year that follows the calendar year in which an election year begins. For example, assume a partnership made a section 444 election to retain its taxable year for its taxable year beginning October 1, 1987 and as a result made a required payment under section 7519 for such year. Further assume that P terminates its election for its taxable year beginning October 1, 1988. Based upon these facts, P will receive a timely refund, but no earlier than April 15, 1989.

F. *"Re-activating" an S election.*

Many corporations timely filed Form 2553 to elect S status for a taxable year beginning in 1987 and requested that they be given permission to use a fiscal year based upon business purpose. However, many of these corporations did not agree to use a calendar year in the event their business purpose request was denied. Thus, if the Internal Revenue Service denied the corporation's business purpose request, the corporation's S election was terminated.

The Service has received a number of inquiries about whether the corporations described above could "re-activate" their S election by filing a section 444 election. Forthcoming temporary regulations will provide that a corporation's S election may be re-activated in such a case, assuming that the corporation's initial Form 2553 was properly filed, the corporation makes a valid section 444 election, and the reactivation is consented to by all of the shareholders who have owned stock in the corporation at any time during the period the S election would be effective.

V. *Administrative pronouncement.*

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure

---

Guidance Concerning Reorganization Transactions Effected Through Use of State Domestication Statutes

Notice 88-50

This notice announces that, through publication of Rev. Rul. 88-25, page 8, this Bulletin, the Internal Revenue Service will provide guidance concerning the application of section 368(a)(1)(F) of the Internal Revenue Code to the "domestication" of a foreign corporation pursuant to a state domestication statute. State domestication statutes (which are also known as corporate migration or corporate continuance statutes) allow an entity to transfer its place of incorporation without requiring the incorporation of a new legal entity. The Revenue Ruling concludes that there is a transfer of assets and liabilities from the foreign corporation to the domesticated U.S. corporation and a distribution by the foreign corporation to its shareholders of the stock in the domesticated corporation.

In addition, the ruling holds that a domestication constitutes a reorganization under section 368(a)(1)(F) of the Code. Generally, applicable reorganization provisions of the Code will provide nonrecognition treatment to the foreign corporation and its shareholders. In certain circumstances, however, nonrecognition treatment will be contingent upon compliance with section 367(b), which generally govern international reorganizations, or section 897(d) or (e), which affect international reorganizations involving U.S. real property interests.

The regulations under section 367 of the Code will be revised to require the closing of the taxable year in all reorganizations of a foreign corporation into a domestic corporation (or *vice versa*) and to clarify that there is an actual or constructive transfer of assets and exchange of stock in all inbound, outbound and foreign to foreign reorganizations. *See* Notice 87-29, 1987-1 C.B. 474. The closing of the taxable year requirement will not generally apply to reorganizations under section 368(a)(1)(F) within the same Country.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure. See Rev. Rul. 87-138, 1987-2 C.B. 287.

Finally, the Service is willing to provide further guidance on additional issues raised by the domestication of a foreign corporation. Written questions and comments should be addressed to:

Associate Chief Council (International and Technical)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224
Attn: CC:C:3:Br.13 Rm. 5135

Nonaccrual-Experience Method of Accounting Under Section 448(d)(5)

Notice 88-51

Background.

The purpose of this notice is to provide guidance to taxpayers regarding the nonaccrual-experience method of accounting allowed under section 448(d)(5) of the Internal Revenue Code.

Section 448(d)(5) of the Code provides that any person using an accrual method of accounting with respect to amounts to be received for the performance of services by such person shall not be required to accrue any portion of such amounts which (on the basis of experience) will not be collected (the "nonaccrual- experience method"). The provisions of section 448(d)(5) do not apply to any amount if interest is required to be paid on such amount or if there is any penalty for failure to timely pay such amount.

On June 16, 1987, proposed and temporary regulations interpreting section 448 were published in the Federal Register (52 FR 22764, T.D. 8143) [1987-2 C.B. 121]. Section 1.448-2T provides guidance with respect to the nonaccrual-experience method under section 448(d)(5). Under the nonaccrual-experience method, a taxpayer does not recognize as gross income the estimated uncollectible amount of each receivable. Upon collecting the account receivable, the taxpayer recognizes additional gross income reflecting the amount collected which the taxpayer did not initially expect to collect. Further, the taxpayer may not deduct as a bad debt under section 166 any amount which the taxpayer did not previously take into income under the nonaccrual-experience method with respect to a wholly or partially worthless account receivable.

Nonaccrual-Experience Method and Periodic System.

Section 1.448-2T(e)(3) requires the taxpayer to separately apply the nonaccrual-experience method to each of its accounts receivable that is eligible for such method (the "separate receivable system"). The legislative history of section 448 provides that "the Secretary of the Treasury may provide a periodic system of accounting for billings, that, on the basis of experience, will not be collected where the periodic system results in the same taxable income as would be the case were each receivable recorded separately." H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 608 (1985) [1986-3 C.B. (Vol. 2)].

In the preamble to T.D. 8143, the Internal Revenue Service, while noting that the regulations did not provide a periodic system, specifically invited comment on the operation of any such system for applying the nonaccrual-experience method, including the manner of accounting for wholly or partially worthless debts under that system. The Internal Revenue Service received several taxpayer submissions in response to the request for comment. The submissions suggested specific methods of implementing the periodic system and urged the Service to allow such a system in order to avoid administrative complexities and costs associated with the separate treatment of each account receivable under the nonaccrual-experience method. Accordingly, this notice provides a periodic system for using the nonaccrual-experience method (the "periodic system"). The present separate receivable system under section 1.448-2T(e)(3) continues to be available as an alternative to taxpayers using the nonaccrual-experience method.

The Periodic System.

The periodic system applies the nonaccrual-experience method of accounting through a method somewhat similar to a reserve method. The periodic system is based on the aggregate amount of accounts receivable to be received by the taxpayer for the performance of services. A taxpayer using the periodic system must establish an account representing the aggregate amounts that the taxpayer estimates will not be collected with respect to all of its accounts receivable in that trade or business eligible for the nonaccrual-experience method ("eligible" accounts receivable), based on the six-year moving average formula provided in section 1.448-2T(e)(2). At the end of the taxable year, the taxpayer must adjust the amount in the account to reflect the aggregate amount that the taxpayer estimates will not be collected on the accounts receivable outstanding at year-end. The taxpayer must offset the amount of the year-end adjustment by an adjustment increasing or decreasing gross income, as appropriate. Thus, the taxpayer must offset an adjustment increasing the amount of the account for uncollectible amounts by an adjustment decreasing gross income. Similarly, the taxpayer must offset an adjustment decreasing the amount of the account by an adjustment increasing gross income.

The periodic system requires the taxpayer to charge directly to bad debt expense wholly or partially worthless accounts receivable which it charges off during the taxable year. In determining the amount charged to bad debt expense for those worthless accounts receivable, the taxpayer must disregard the estimated uncollectible amounts pertaining to the accounts receivable. Similarly, the taxpayer must disregard the estimated uncollectible amounts of accounts receivable when it accounts for the collection of those receivables.

The periodic system further requires the taxpayer to use the six-year moving average formula to estimate the total amount that it will not collect on all of its eligible accounts receivable outstanding at the end of the taxable year, including receivables outstanding at the end of the prior taxable year. In contrast, the separate receivable system requires the taxpayer to determine only once the amount of a particular receivable it expects not to collect using the nonaccrual-experience method, regardless of the term of the particular receivable.

Example of Periodic System.

The following example illustrates the periodic system under the nonaccrual-experience method.

(a) X, a calendar-year accrual-method taxpayer, changes to the nonaccrual-experience method of accounting for its first taxable year beginning after December 31, 1986. As of January 1, 1987, X has 10 eligible accounts receivable, each with a $1,000 face amount, for a total accounts receivable balance of $10,000. Under the six-year moving average formula, X estimates that it will not collect 10% ($1,000) of the $10,000 total amount due as of January 1, 1987. (The $1,000 amount equals the section 481 (a) adjustment of X's change in method of accounting to the nonaccrual-experience method of 1987. See section 1.448-2T(g).) During 1987, X (i) determines that one account receivable on hand at January 1, 1987, is wholly worthless; (ii) collects in full eight of the accounts receivable on hand at January 1, 1987; (iii) does not write off or collect the remaining account receivable on hand at January 1, 1987, which remains on hand at December 31, 1987; and (iv) provides additional services which generate 19 new eligible accounts receivable on hand as of December 31, 1987, each with a $1,000 face amount, thus otherwise recognizing gross income of $19,000.

(b) Under the periodic system, X must charge bad debt expense for $1,000 with respect to the account receivable that X determines is wholly worthless. (In contrast, X must charge bad debt expense for $900 under the separate receivable system.) In addition, under the periodic system, X must reduce accounts receivable by $8,000 for the eight accounts receivable that X collected in full. (In contrast, under the separate receivable system, X must reduce accounts receivable by $7,200 and increase gross income by $800.)

(c) Assume that X applies the six-year moving average formula to all X's accounts receivable at December 31, 1987, and estimates that 9% of those receivables are uncollectible. Thus, the account for the aggregate amounts that X estimates are uncollectible must equal $1,800 (9% of $20,000). Under the periodic system, X must increase the balance in the account for aggregate estimated uncollectible amounts from $1,000 to $1,800. Thus, X must increase the account for aggregate estimated uncollectible amounts by $800 and decrease gross income by $800. (In contrast, under the separate receivable system, X calculates the estimated uncollectible amounts only with respect to new accounts receivable on hand at year-end and adjusts gross income accordingly. Thus, X does not recognize $1,710 of gross income for the $19,000 of new accounts receivable recognized in 1987.)

(d) Under the periodic system, the net taxable income which X recognizes in 1987 is $10 more than the net taxable income which X would recognize under the separate receivable system. This $10 increase in net taxable income under the periodic system results from a positive $910 difference in gross income under the periodic system for the accounts receivable that X generated during 1987, reduced by the $800 difference in treatment under the periodic system for the eight accounts receivable that X collected in full in 1987, and further reduced by the $100 difference in treatment under the periodic system for the account receivable charged off during 1987. Therefore, X's net balance reflected in the accounts receivable and reserve account at December 31, 1987, is $10 more under the periodic system than under the separate receivable system.

Treatment of Periodic System.

The taxpayer's use of the separate receivable system or the periodic system is a method of accounting under all provisions of the Code. Thus, for example, a taxpayer using the separate receivable system or the periodic system for a particular trade or business may not change its method of accounting to the other system for that trade or business unless it obtains the consent of the Commissioner to the change. Nevertheless, a taxpayer who used the separate receivable system for its taxable years beginning in 1987 may automatically change its method of accounting to the periodic system for its taxable year beginning in 1988. The taxpayer may effect the automatic change in method of accounting by (i) establishing an account (with a "credit" balance) under the six-year moving average formula representing estimated uncollectible amounts for all eligible accounts receivable on hand at the beginning of its 1988 taxable year; (ii) increasing (*i.e.*, "debiting") its accounts receivable on hand at the beginning of its 1988 taxable year by the amount described in clause (i); and (iii) applying the periodic system to all activities occurring in 1988 and thereafter.

In addition, a taxpayer may change to the periodic system of accounting under the provisions of section 1.448-2T (h), which presently apply to taxpayers using the separate receivable system. Thus, for example, an accrual-method taxpayer may change to the periodic system for its first taxable year beginning after December 31, 1986. Similarly, a taxpayer changing from the cash method to an overall accrual method of accounting under section 448 may change to the periodic system for the year in which it changes to an overall accrual method of accounting. All other provisions of the regulations apply equally to taxpayers using the nonaccrual-experience method, whether they use the separate receivable system or the periodic system. Thus, for example, the regulatory provisions governing the availability of the nonaccrual-experience method to a taxpayer's various accounts receivable apply equally to the separate receivable and periodic systems.

The Internal Revenue Service recognizes that the use of the periodic system may result in small differences in taxable income in comparison to the results achieved by the use of the separate receivable system, particularly in years when the taxpayer's bad debt experience changes. The taxpayer may use the periodic system in spite of the resulting differences if it consistently maintains its use of the periodic system.

Administrative Pronouncement.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Foreign Insurance Companies; Effectively Connected Income; Estimated Tax Payments

Notice 88-52

This notice describes the effect of section 842 of the Internal Revenue Code of 1986 on the taxable income of foreign insurance companies and provides guidance on making estimated tax payments for taxable years beginning after December 31, 1987.

Section 10242 of the Omnibus Reconciliation Act of 1987, 101 Stat. 1330, Pub. L. No. 100-203, amended section 842 of the Code to provide a minimum amount of new investment income that is effectively connected with the conduct of an insurance business within the United States. This provision applies to any foreign company carrying on an insurance business within the United States that would qualify under part I (relating to the taxation of life insurance companies) or part II (relating to the taxation of other insurance companies) of subchapter L of the Code if it were a domestic corporation. The effect of the provision is that income from sources without the United States of a foreign life or property and casualty insurance company that carries on an insurance business within the United States may be treated as effectively connected with that trade or business and subject to taxation on a net basis.

Under section 842 of the Code as amended, the net investment income of a foreign insurance company that is effectively connected with the conduct of an insurance business in the United States may not be less than the required U.S. assets of the company multiplied by the domestic investment yield applicable to the company for the taxable year or, if the company elects, by its worldwide current investment yield.

The required U.S. assets of a foreign insurance company for any taxable year are determined by multiplying the mean of the company's total insurance liabilities on U.S. business by the domestic asset/liability percentage applicable to the company. The Secretary will prescribe for each year a separate domestic asset/liability percentage for foreign life insurance companies and foreign property and casualty insurance companies. The domestic asset liability percentage for each type of insurance company equals a fraction, the numerator of which is the mean assets of domestic companies of the same type and the denominator of which is the mean liabilities of domestic companies of the same type.

The Secretary also will prescribe for each year a separate domestic investment yield for foreign life insurance and foreign property and casualty insurance companies. The investment yield for each type of insurance company equals a fraction, the numerator of which is the net investment income of domestic insurance companies of the same type and the denominator of which is the mean of the aggregate assets held for the production of investment income of domestic companies of the same type. In lieu of using the domestic investment yield, a foreign insurance company may elect to use its worldwide current investment yield. The worldwide current investment yield equals a fraction, the numerator of which is the net investment income of the company from all sources and the denominator of which is the mean of the worldwide assets of the company that are held for the production of investment income.

The Secretary has not yet determined the asset/liability percentages and the domestic investment yields for taxable years beginning after December 31, 1987. Therefore, to compute the estimated tax and the installment payments of estimated tax for the first such year, a foreign insurance company (whether a life or a property and casualty company) will, until publication by the Secretary of the domestic asset/liability percentages and the domestic investment yields, be allowed to compute its tax due on investment income by using the actual investment income that is effectively connected with the conduct of the company's U.S. trade or business. Any reduction in a required installment resulting from using a company's actual investment income rather than the amount of investment income computed under section 842 of the Code must be recaptured by increasing the amount of the first installment payment due after publication of the domestic asset/liability percentages and the domestic investment yields.

No additions to tax will be made because of any underpayment of estimated tax for any required installment in the first taxable year beginning after December 31, 1987 due prior to the publication of the domestic asset/liability percentages and the domestic investment yields if: (1) the foreign insurance company timely computes and pays such required installment based on its actual investment income, and (2) the foreign insurance company's first estimated tax payment due after publication of the domestic asset/liability percentages and the domestic investment yields (the "subsequent installment payment") meets the conditions of paragraphs (1) or (2), below.

(1) *Annualization exception.* The subsequent installment payment is sufficient if the amount of the payment satisfies the requirements of section 6655(e) of the Code with respect to all applicable taxes specified in

section 6655(g). Thus, the foreign insurance company must determine its annualized taxable income under section 6655(e)(2)(A)(i)(II), (III), or (IV), whichever is applicable, and compute the resulting tax using the domestic asset/liability percentages and the domestic investment yields. The resulting tax shall include the alternative minimum tax under section 55 and the environmental tax under section 59A and may take credits into account to the extent permitted under section 6655(g). The sum of this subsequent installment payment and the earlier installment payment or payments of the foreign insurance company must equal or exceed the following percentages of the tax so computed:

(i) 45 percent (50 percent × 90 percent), if the subsequent installment payment is the second installment payment for the taxable year;

(ii) 67.5 percent (75 percent × 90 percent), if the subsequent installment payment is the third installment payment for the taxable year; or

(iii) 90 percent, if the subsequent installment payment is the fourth installment payment for the taxable year.

(2) *Installment payments equal to applicable percentage of tax shown on return*. The subsequent installment payment is sufficient if the sum of that payment and the earlier installment payment or payments of the foreign insurance company equals or exceeds the applicable percentages listed in paragraph (1)(i), (ii), or (iii), above, of the tax shown on the return of the foreign insurance company for the taxable year to which the installment payments relate. The tax shown on the return includes all taxes specified in section 6655(g) of the Code.

In addition, no additions to tax will be made if each installment of a foreign insurance company that is not a large corporation, as defined in section 6655(g)(2) of the Code, equals 100 percent of the tax shown on the return of the foreign insurance company for the preceding taxable year multiplied by 25 percent, provided that the requirements of the flush language of section 6655(d)(1) are met.

A foreign insurance company that computes its estimated tax installment payments pursuant to this Notice should write "Subject to section 842" at the top of Form 2220 (Underpayment of Estimated Tax by Corporations).

Effective Date

This document serves as an "administrative pronouncement" as that term is used in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure. *See* Rev. Rul. 87-138, 1987-2 C.B. 287. Taxpayers may rely on this notice for the first taxable year beginning after December 31, 1987.

Continuation of Code Section 897(i) Elections by Netherlands Antilles Companies; Anti-Treaty Shopping Rules; Extension of Deadlines in Notice 88-1

Notice 88-53

This notice extends until September 1, 1988, the May 2, 1988, deadline set forth in section 3 of Notice 88-1, page 471, this Bulletin. Notice 88-1 provided guidance on the status of elections by Netherlands Antilles companies and certain other treaty country corporations under section 897(i) of the Internal Revenue Code of 1986. Such elections provide that a foreign corporation will be treated as a domestic corporation for purposes of sections 897, 1445 and 6039C of the Code. A section 897(i) election can be made only if the foreign corporations is entitled to nondiscriminatory treatment under any treaty obligation of the United States.

On January 11, 1988, the Internal Revenue Service issued Notice 88-1, which provided, *inter alia*, guidance concerning: (a) the impact of the termination of the income tax treaty between the United States and the Netherlands Antilles on section 897(i) elections made by Netherlands Antilles companies; and (b) the application of the anti-treaty shopping provision of the Treaty of Friendship, Commerce and Navigation between the United States and the Kingdom of the Netherlands, extended to the Netherlands Antilles under Article XXIV thereof (8 UST 2043; TIAS 3942 (1957)) (the "Antilles FCN Treaty"), and the anti-treaty shopping provisions of similar treaties.

In Notice 88-1 the Service stated that companies formed under the laws of the Netherlands Antilles which are controlled, directly or indirectly, by nationals of third countries may not rely on the nondiscrimination provisions of the Antilles FCN Treaty as the basis for making a section 897(i) election after May 2, 1988. In addition, companies entitled to the benefits of the nondiscrimination provisions contained in any other friendship, commerce and navigation treaty (an "FCN treaty") which contains an antiy-treaty shopping provision similar to Article XXII(1)(e) of the Antilles FCN Treaty may not rely on such nondiscrimination provision after such date if the company is controlled, directly or indirectly, by nationals of third countries.

A company is considered not to conform to the anti-treaty shopping provisions of an FCN treaty if it does not satisfy the anti-treaty shopping provision of an FCN treaty at either the time the election is made or the time of an acquisition or disposition of a U.S. real property interest. Any such company which makes a section 897(i) election in reliance on the nondiscrimination provisions of an FCN treaty (or is treated as having made such an election pursuant to section 2 of Notice 88-1) is referred to herein as having made an "FCN treaty-shopping election."

Notice 88-1 further provides that foreign corporations that have made an FCN treaty-shopping election on or before May 2, 1988, will be bound by, and receive the benefits of, that election only as provided in section 3 of Notice 88-1. Section 3 of Notice 88-1 provides that certain transactions or events must occur by May 2, 1988, in order for an FCN treaty-shopping election to continue in effect after May 2, 1988. Section 3 of Notice 88-1 further provides that an FCN treaty-shopping election made on or after May 3, 1988, will not be valid.

This notice modifies Notice 88-1 to provide that the May 2, 1988, and May 3, 1988, deadlines are extended to September 1, 1988 and September 2, 1988. Accordingly, all references in Notice 88-1 to "May 2, 1988" are changed to "September 1, 1988"; all references in Notice 88-1 to May 3, 1988 are changed to "September 2, 1988." All other terms and provisions of Notice 88-1 remain unchanged.

This document serves as an "administrative pronouncement" as that term is used in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

EFFECT ON OTHER DOCUMENTS

Notice 88-1 is modified.

Application of IRC Section 149(b) to State or Local Bonds Issued in Connection with EPA State Water Pollution Control Revolving Fund Program

Notice 88-54

This notice provides guidance regarding the application of section 149(b) of the Internal Revenue Code to State or local bonds issued in connection with the State Water Pollution Control Revolving Fund Program under Title VI of the Clean Water Act (Program).

The Environmental Protection Agency (EPA) is authorized under the Program to make capitalization grants to States to help them establish State revolving funds for financing water pollution control facilities. The States may use the grants to make loans to local governments to finance the construction of water pollution control facilities, to establish debt service reserve funds for bonds the proceeds of which are to be used to make such loans, and for various other purposes.

On January 28, 1988, EPA issued final initial guidance relating to implementation of the Program (EPA guidance). The EPA guidance provides that payment of capitalization grants will be made in the form of a letter of credit in order to minimize the outlay burden on the Federal Government. States will drawn down funds under the letter of credit in accordance with procedures outlined in the EPA guidance. If the grant is used to establish a debt service reserve fund for bonds, draw-downs generally will occur at a fixed rate based on the national, historic outlay rate. The draw-down rate will be accelerated if necessary to prevent an imminent default on the bonds.

Section 149(b) of the Code generally provides that a State or local bond the payment of principal or interest on which is guaranteed (directly or indirectly) by the Federal Government or any agency or instrumentality thereof will not qualify for tax exemption under section 103(a). Regulations to be issued under section 149(b) will provide that payments of principal and interest on State and local bonds will not be considered Federally guaranteed within the meaning of section 149(b) solely by reason of the fact that the debt service reserve fund for the bonds (or principal or interest on the bonds) may be funded with capitalization grants awarded under the Program in accordance with procedures outlined in the EPA guidance.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure. *See* Rev. Rul. 87-138, 1987-2 C.B. 287.

Modification of Notice 88-30

Notice 88-55

This notice extends until May 31, 1988, the period during which certain persons will be deemed to be registered as a producer under section 4101 of the Internal Revenue Code with respect to sales of fuel taxable under section 4091 of such Code, in accordance with the provisions of Notice 88-30, page 497, this Bulletin, as corrected by Announcement 88-64, 1988-16 I.R.B. 35. Notice 88-30 described issues arising from the changes made by section 10502 of the Revenue Act of 1987 (P.L. 100-203, 101 Stat. 1330 ("1987 Act")) to the excise tax on diesel fuel and aviation fuel that the Internal Revenue Service intends to address in regulations. The 1987 Act added sections 4091, 4092, and 4093 to the Code, which, beginning on April 1, 1988, moved the point of collection of the diesel fuel and aviation fuel tax from the sale by the retailer to the sale by the producer. See also Notice 88-44, page 528, this Bulletin, relating to the floor stocks imposed under section 10502(f) of the 1987 Act of taxable fuel held by a taxable person on April 1, 1988.

Section III(B)(1)(b) of Notice 88-30 states that the regulations relating to sales of fuel taxable under section 4091 will provide that on or after April 1, 1988, and before May 1, 1988, taxable fuel may be sold taxfree to a person who (but for not being registered under section 4101) meets the definition of the term "producer" as set forth in section III(B)(1)(a) of Notice 88-30, and that such person shall be deemed to be a registered producer during such period, provided that—

(i) The seller of taxable fuel to such person in the normal course of its business maintains on file copies of invoices of sales of taxable fuel showing the name of the purchaser, the date of sale, the type and volume of product sold, and a written statement clearly indicating that the purchaser is a producer who has furnished a certification required by section III(B)(1)(b)(ii) of Notice 88-30 to the seller, and

(ii) The seller obtains from such purchaser and keeps on file a certification, signed under penalties of perjury by a person having authority to bind the purchaser, stating the name, address, employer identification number of the purchaser, and the title of the person signing the certification.

Section III(B)(1)(b)(ii) of Notice 88-30 also provided that the certification required by such section may cover sales of taxable fuel to a person who (but for not being registered under section 4101) meets the definition of the term "producer" as set forth in section III(B)(1)(a) of Notice 88-30, for the period from April 1, 1988, to April 30, 1988, inclusive, and shall take the following form:

"The undersigned purchaser ("Purchaser") hereby certifies that Purchaser is a producer of taxable fuel who is a refiner, compounder, blender, or wholesale distributor of a taxable fuel or a dealer selling any taxable fuel exclusively to producers of such taxable fuel. If Purchaser claims an exemption as a wholesale distributor, Purchaser certifies that Purchaser sells a taxable fuel to producers, retailers, or to users who purchase in bulk quantities and deliver into bulk storage tanks.

"Purchaser understands that any fraudulent use of this certification to purchase any taxable fuel free of tax will subject Purchaser to penalties of perjury, which may include fine and imprisonment."

E.I.N.: ________ ________
Address: ________ by ________
________ Title ________

Section III(B)(1)(b) of Notice 88-30 further states that the regulations will provide that a person who meets the requirements of such section shall, for the period beginning April 1, 1988, and ending before May 1, 1988, be deemed to be a registered producer of taxable fuel for purposes of purchasing fuel tax-free as a producer under section 4093(b), and for purposes of incurring liability for the tax imposed by section 4091.

Section III(B)(1)(c) of Notice 88-30 states that the regulations will provide that on or after May 1, 1988, taxable fuel may be sold tax-free by a producer or importer of taxable fuel to a producer of taxable fuel under section 4091, provided that certain requirements are met.

The Internal Revenue Service recognizes that, because of time constraints, many persons who (but for not being registered under section 4101) meet the definition of the term "producer" have not yet received the Certificate of Registry required under Notice 88-30 in order to purchase taxable fuel tax-free on or after May 1, 1988. Therefore, the regulations will provide that the period during which such persons will be deemed to be a registered producer of taxable fuel for purposes of purchasing fuel tax-free as a producer under section 4093(b), and for purposes of incurring liability for the tax imposed by section 4091 is extended to include the period from May 1, 1988, to May 31, 1988, inclusive. Accordingly, a certification furnished to a seller under section III(B)(1)(b)(ii) of Notice 88-30 may be modified in writing to apply to the period from April 1, 1988, to May 31, 1988, inclusive.

Section III(B)(1)(d) of Notice 88-30 provides that an application for registry submitted on or before April 30, 1988, will be approved on a conditional basis only. In accordance with the rule of the preceding paragraph, the period during which an application for registry will be approved on a conditional basis only is also extended through May 31, 1988.

EFFECT ON OTHER DOCUMENTS

Notice 88-30 is modified.

ADMINISTRATIVE PRONOUNCEMENT

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Employee Stock Ownership Plans; Diversification Requirements

Notice 88-56

This notice provides guidance, in the form of questions and answers, with respect to certain provisions of the Tax Reform Act of 1986, concerning the diversification of investments requirement applicable to employee stock ownership plans (ESOPs) under section 401(a)(28) of the Internal Revenue Code of 1986 (Code) and the rules governing the taxation of qualified plan distributions under section 72.

Until further guidance is published, the guidance provided by these questions and answers may be relied upon by taxpayers to design and administer plans and to determine the tax treatment of plan distributions. The Service will apply the questions and answers in issuing determination letters, opinion letters, other rulings and in auditing returns with respect to taxpayers and plans. If future guidance is more restrictive than this notice, such guidance will be applied without retroactive effect. No inference should be drawn, however, regarding issues not addressed in this notice which may be suggested by a particular question and answer or as to why certain questions, and not others, are included. Retroactive protection will not necessarily be afforded with respect to any such inferred guidance.

A. Code Section 401(a)(28)

Q-1: Which employer securities held by an ESOP or a tax credit ESOP are subject to the diversification of investments requirement of section 401(a)(28) of the Code?

A-1: Employer securities acquired by or contributed to an ESOP or a tax credit ESOP after December 31, 1986, are subject to the diversification of investments requirement of section 401(a)(28). Thus, for example, dividends paid to an ESOP after December 31, 1986, with respect to employer securities acquired by or contributed to the plan on or before such date are subject to the diversification requirement of section 401(a)(28) if such dividends are either paid in the form of employer securities or paid in cash or other property that is subsequently used to acquire employer securities. However, employer securities acquired by or contributed to an ESOP on or before December 31, 1986, are not subject to the diversification requirements. See Q&A-7 and Q&A-8 for an exception to section 401(a)(28) for certain de minimis amounts of employer securities.

Q-2: In what circumstances are employer securities actually acquired by or contributed to a tax credit ESOP after December 31, 1986, treated as acquired by or contributed to the tax credit ESOP on or before December 31, 1986?

A-2: Employer securities (within the meaning of section 409(1)) acquired by or contributed to a tax credit ESOP after December 31, 1986, are deemed, for purposes of section 401(a)(28), to be acquired by or contributed to the ESOP before January 1, 1987, if: 1) with respect to such securities, a tax credit was calculated under section 41(a) of the Internal Revenue Code of 1954 with reference to compensation paid or accrued before January 1, 1987, by the employer to employees under a tax credit ESOP; 2) the securities were acquired or contributed within the time period provided in section 404(a)(6) plus such additional time period allowed for contributions to a tax credit ESOP under section 41(c)(2) and 41(c)(4) of the Internal Revenue Code of 1954; and 3) the securities were allocated as of a date no later than the last day of the plan year ending within the employer's first taxable year ending on or after December 31, 1986. Thus, such employer securities are not subject to the diversification requirements of section 401(a)(28).

Q–3: In what circumstances are employer securities actually acquired by an ESOP or tax credit ESOP after December 31, 1986, treated as acquired by or contributed to the ESOP or tax credit ESOP on or before December 31, 1986?

A–3: Employer securities acquired by an ESOP or tax credit ESOP after December 31, 1986, will be deemed, for purposes of section 401(a)(28), to have been acquired by or contributed to the ESOP on or before December 31, 1986, in the following circumstances:

A) Cash or other assets derived from the disposition of employer securities pursuant to a corporate reorganization or acquisition attempt (whether or not successful) which are used to purchase other employer securities will be treated as acquired by or contributed to the ESOP on or before December 31, 1986, if the period between the disposition and the reinvestment does not exceed 90 days or such longer period as may be granted by the Commissioner under rules similar to those of Treas. Reg. §1.46–8(e)(10). For dispositions after June 8, 1988, no extensions will be granted unless applied for within 90 days after the disposition.

B) Employer securities acquired by an ESOP or tax credit ESOP after December 31, 1986, which were purchased with contributions made to the ESOP in cash on or before December 31, 1986 (including employee contributions) will be treated as acquired by or contributed to the ESOP on or before December 31, 1986, if such contributions were used to purchase employer securities within 60 days after the date of the contribution.

C) Employer securities acquired by an ESOP or tax credit ESOP after December 31, 1986, which were purchased with earnings or dividends paid in cash to an ESOP on or before December 31, 1986, will be treated as acquired by or contributed to the ESOP on or before December 31, 1986, if such earnings or dividends were used to purchase employer securities within 60 days from the date of payment to the ESOP.

D) Employer securities acquired by an ESOP after December 31, 1986, which were purchased with the proceeds of an exempt loan (under section 4975) received by the ESOP in cash on or before December 31, 1986, will be treated as acquired by or contributed to the ESOP on or before December 31, 1986, if such proceeds are invested in employer securities within 60 days of the receipt of the proceeds by the ESOP.

E) Employer securities acquired by an ESOP after December 31, 1986, which were purchased with amounts transferred to an ESOP on or before December 31, 1986, pursuant to a section 4980 transaction will be treated as acquired by or contributed to the ESOP on or before December 31, 1986, if the amounts are used to purchase employer securities within the time period prescribed in section 4980(c)(3)(B).

Q–4: If an ESOP does not account for employer securities acquired by or contributed to the plan after December 31, 1986, separately from employer securities acquired by or contributed to the plan on or before December 31, 1986, how are the employer securities subject to diversification determined?

A–4: Solely for purposes of section 401(a)(28), it is presumed that unless a plan separately accounts for employer securities acquired by or contributed to the plan after December 31, 1986, the employer securities allocated to participants' accounts after December 31, 1986, consist, first, of those employer securities acquired by or contributed to the plan after December 31, 1986, and second, of employer securities acquired by or contributed to the plan on or before December 31, 1986.

Q–5: Do special rules apply for determining employer securities subject to diversification for an ESOP or tax credit ESOP which adopts model plan amendments?

A–5: If the sponsor of an ESOP or tax credit ESOP adopts the applicable model plan amendments contained in Notice 87–2, 1987–1 C.B. 396, on or before the date specified in section 1140 of the Tax Reform Act of 1986, the portion of a qualified participant's account balance attributable to employer securities acquired by or contributed to the ESOP after December 31, 1986, may be determined under either Q&A–4 of this notice or by multiplying the number of shares of employer securities allocated to a qualified participant's account by a fraction, the numerator of which is the number of shares of securities acquired by or contributed to the plan after December 31, 1986, and allocated to participant accounts, and the denominator of which is the total number of shares held by the plan at the plan valuation date nearest to the date on which the participant becomes a qualified participant.

In addition, see Q&A–17 in the case of a plan which determined the employer securities subject to the diversification requirement in conformity with the model plan amendments on or before June 8, 1988.

Q–6: May an ESOP or tax credit ESOP allocate employer securities acquired by or contributed to the ESOP after December 31, 1986, to participant's accounts on a different basis than employer securities acquired by or contributed to the ESOP before January 1, 1987?

A–6: Yes. However, the plan's allocation method must meet the requirements of section 401(a)(4). Thus, an ESOP or tax credit ESOP that allocates among participants both employer securities acquired by or contributed to the ESOP after December 31, 1986, (post-86 securities) and employer securities acquired by or contributed to the ESOP before January 1, 1987, (pre–87 securities) will fail to satisfy section 401(a)(4) if such plan uses an allocation method that disproportionately allocates post–86 securities in favor of the employees described in section 401(a)(4).

Q–7: What amount of employer securities held by an ESOP or tax credit ESOP constitutes a de minimis amount of employer securities that is not subject to the diversification of investments requirement of section 401(a)(28)?

A-7: If the fair market value (determined at the plan valuation date immediately preceding the first day on which a qualified participant is eligible to make a diversification election) of the employer securities acquired by or contributed to an ESOP after December 31, 1986, and allocated to a qualified participant's account is $500 or less, then such employer securities will be considered to constitute a de minimis amount of employer securities that is not subject to the diversification of investments requirement of section 401(a)(28). A plan may elect to use a de minimis amount of less than $500.

For purposes of determining whether the amount of employer securities acquired by or contributed to an ESOP after December 31, 1986, and allocated to the account of a qualified participant exceeds the de minimis amount described above, employer securities held in accounts of all ESOPs or tax credit ESOPs maintained by an employer corporation and by members of the controlled group of corporations (within the meaning of section 414(b), (c), (m) or (o)) which includes the employer corporation shall be considered as held by the same plan.

Q-8: What amount of employer securities held by an ESOP or tax credit ESOP is subject to diversification if the fair market value of the employer securities acquired or contributed after December 31, 1986, exceeds the de minimis amount?

A-8: If the fair market value of the employer securities acquired by or contributed to the plan after December 31, 1986, and allocated to the account of a qualified participant exceeds the de minimis amount for any year of a participant's qualified election period, then all shares allocated to the account of a qualified participant which were acquired or contributed after December 31, 1986, shall be subject to the diversification requirements of section 401(a)(28) in each remaining year of a participant's qualified election period.

Q-9: What portion of a qualified participant's account is subject to the diversification of investments requirement?

A-9: The portion of a qualified participant's account subject to the diversification election in all years in the qualified election period, other than the final year of such period, is equal to: (1) 25 percent of the total number of shares of employer securities acquired by or contributed to the plan after December 31, 1986, that have ever been allocated to a qualified participant's account on or before the most recent plan allocation date; less (2) the number of shares of employer securities previously distributed, transferred, or diversified pursuant to a diversification election made after December 31, 1986. See Q&A-7 and Q&A-8 regarding the exception for de minimis amounts. The resulting number of shares may be rounded to the nearest whole integer. With respect to a qualified participant's final diversification election, "50 percent" is substituted for "25 percent" in determining the amount subject to the diversification election.

The following example illustrates the rules of this Q&A:

Employee (E), a participant in a calendar year ESOP maintained by Corporation X, is first eligible to make a diversification election in 1989. The fair market value of X corporation stock was $10 per share on December 31, 1988. As of December 31, 1988, E's account contains 100 shares of X stock which were contributed to the plan after December 31, 1986 (post-86 stock). The X stock in E's account is subject to the diversification requirements of section 401(a)(28) because the fair market value of the post-86 stock exceeds $500 (See Q&A-7, supra). The ESOP must permit E to elect to diversify up to 25 shares of the post-86 stock allocated to his account (25% of 100 shares). E must be eligible to make this election through March 31, 1989. E elects prior to April 1, 1989 to receive a distribution of 25 shares of X stock.

During 1989, X corporation contributes X stock to the ESOP. E's account receives an allocation of 10 shares of X stock with respect to the 1989 employer contribution. As of December 31, 1989, E's account contains 85 shares of post-86 stock (110 shares—25). The portion of E's account subject to diversification following the 1989 plan year is calculated as follows: 25% of 110 shares is subject to the diversification election (27 1/2 shares). This amount is then reduced by the number of shares E has previously elected to diversify. Thus, E must be able to elect diversification with respect to an additional 2 1/2 shares of post-86 stock (27 1/2 less 25) through March 31, 1990. This number may be rounded to 3 shares of post-86 stock.

Q-10: Which shares of employer securities must be diversified pursuant to a diversification election?

A-10: The shares of employer securities that are diversified pursuant to a diversification election need not consist of securities acquired by or contributed to the ESOP after December 31, 1986. This is the case even though the determination of the number of shares that must be available for diversification under section 401(a)(28) is based on the number of employer securities acquired by or contributed to the ESOP after December 31, 1986 (See Q&A-9).

However, the shares of employer securities that are diversified pursuant to a diversification election must consist of employer securities that, immediately prior to diversification, are subject to the requirements of section 409(h). Also, in the case of an ESOP that permits participants to receive distributions of employer securities that have been held by the plan for at least 84 months in circumstances other than those described in section 409(d)(1)-(3), section 401(a)(28) overrides the 84 month rule of section 409(d) only to the extent that the shares of employer securities allocated to a qualified participant and diversified pursuant to a diversification election actually consist, first, of employer securities that have satisfied the 84-month rule and, thereafter, of employer securities that continue to be subject to the 84-month rule and have been held by the plan for longer periods of time than other employer securities subject to the 84-month rule.

Q-11: May an ESOP permit the diversification of amounts in excess of those required by section 401(a)(28)(B)?

A-11: Yes. However, amounts in excess of the minimum amount required to be available for diversification under section 401(a)(28)(B) are not treated as available for diversification or as diversified pursuant to section 401(a)(28)(B). Thus, employer securities subject to section 409(d) and in excess of the minimum amount required to be available for diversification under section 401(a)(28)(B) may not be diversified to the extent that such securities may not be distributed under section 409(d). Also, amounts subject to the requirements of section 409(h) and in excess of the minimum amount required to be available for diversification under section 401(a)(28)(B) remain subject to section 409(h) even if such amounts are diversified.

Notwithstanding the foregoing, if a plan permitted the diversification of amounts in excess of the minimum amount required by section 401(a)(28) with respect to employer securities acquired by or contributed to the plan after December 31, 1986, such excess diversification will be treated as required by section 401(a)(28)(B) for purposes of applying sections 409(d) and 409(h) if such diversification was implemented no later than June 8, 1988, reflected a reasonable interpretation and of section 401(a)(28).

Q-12: When is a participant eligible to make diversification elections with respect to his ESOP account?

A-12: Pursuant to section 401(a)(28)(B), a qualified participant must be able to elect to diversify the appropriate portion of his ESOP account balance (as determined under Q&A-9 of this notice) within 90 days after the close of each plan year during the participant's "qualified election period." A "qualified participant" (as defined in section 401(a)(28)(B)(iii) means any employee who has completed at least ten years of participation under the plan and has attained 55 years of age.

Generally, a participant's qualified election period consists of the 5 plan year period beginning with the plan year after the plan year in which the participant first becomes a qualified participant. However, the qualified election period of any employee who became a qualified participant before January 1, 1987, shall not begin before the first plan year beginning after December 31, 1986 and shall continue thereafter for a complete 5 plan year period.

For example, a participant in an ESOP (which uses a calendar plan year) who becomes a qualified participant during 1987 will first be eligible to make a diversification election within the first 90 days of 1989 (within 90 days following the close of the first plan year beginning after 12/31/87). The qualified participant's qualified election period begins in the 1988 plan year and ends with the 1992 plan year. The qualified participant's last diversification election will be within the first 90 days of 1993.

Similarly, for example, in the case of an employee who first became a qualified participant in 1986 or any prior year, the participant's qualified election period would begin with the 1987 plan year and close with the 1991 plan year. The qualified participant must first be given a diversification election within the first 90 days of 1988.

Notwithstanding the foregoing, in the case of an employee who became a qualified participant before January 1, 1987, a plan will not fail to meet the requirements of section 401(a)(28)(B) if such qualified participant is eligible to make the first diversification election no later than September 6, 1988. In addition, for purposes of this paragraph, an employee who became a qualified participant in 1987 and who was treated under the plan, prior to April 9, 1988, as eligible to make the first diversification election on or before June 8, 1988, may be treated as an employee who became a qualified participant before January 1, 1987.

Q-13: What methods can be used by an ESOP or a tax credit ESOP in order to satisfy the diversification of investments requirement with respect to a qualified participant?

A-13: An ESOP or tax credit ESOP will be treated as satisfying the diversification of investments requirement of section 401(a)(28) if:

A) the portion of the participant's account balance that is subject to the diversification election under section 401(a)(28)(B)(i) is distributed to the participant (or made available for distribution under Q&A-15) within 90 days after the last day of the period during which the election can be made;

B) the plan offers at least 3 distinct investment options (which are not inconsistent with regulations prescribed by the Secretary) with respect to the portion that is subject to the diversification election to each participant making an election under section 401(a)(28)(B)(i) and any investment option selected by the participant is implemented no later than 90 days after the last day of the period during which the election can be made; or

C) the plan offers the option to direct the plan to transfer the portion of the participant's account that is subject to the diversification election to another qualified defined contribution plan of the employer that offers at least 3 distinct investment options in accordance with B) above, provided that the transfer is made no later than 90 days after the last day of the period during which the election can be made. Such transfer must comply with applicable qualification requirements, including sections 414(l), 411(d)(6) and 401(a)(11).

The diversification of investments requirement for a year will be satisfied if the number of employer securities distributable under the plan during the 90 days after the last day of the period in which a diversification election can be made equals or exceeds the number of employer securities subject to diversification for the year. Thus, for example, if a tax credit ESOP provides for distribution of employer securities 84 months after allocation, and such employer securities are distributed during the 90 days after the last day of the period in which a diversification election can be made, such distribution may be used to fulfill the diversification requirement if it is equal to 25% (50% for the last year) or more of the employer securities subject to diversification under section 401(a)(28)(B).

Q-14: To what extent is a distribution in satisfaction of a participant's diversification election subject to certain other provisions of the plan or Code governing distributions?

A-14: Amounts that are required to be available for diversification and are diversified by means of distribution, as permitted under A-13(A), generally are treated as amounts that are not held by an ESOP. Thus, a distribution in satisfaction of a diversification election is not subject to the right to demand employer securities requirement of section 409(h) and may be made notwithstanding the 84 month holding period requirement of section 409(d). However, a distribution in satisfaction of a diversification election is subject to the provisions of section 409(h) concerning the exercise of a put option by participants to the extent that the distribution consists of employer securities. Also, see Q&A-10 for special rules applicable to the interaction of sections 401(a)(28) and 409(d). Finally, a distribution in satisfaction of a diversification election does not fail to satisfy section 411(d)(6) merely because it is not available in the form of employer securities or it is available only as a single sum distribution.

However, a distribution or transfer in satisfaction of a diversification election is eligible for the special exception for ESOP benefits under section 401(a)(11)(C). See, however, Q&A-16 with respect to the inapplicability of this special ESOP benefit exception for distributions of amounts previously diversified pursuant to section 401(a)(28) in accordance with either Q&A-13(B) or Q&A-13(C).

Finally, a distribution in satisfaction of a diversification election must satisfy section 411(a)(11) concerning the consent of the participant to a distribution, but is not subject to the rules, under section 401(a), restricting the distribution of plan benefits before the termination of employment (in the case of a pension plan) or the occurrence of certain other events (in the case of a profit-sharing plan).

Q-15: Has a plan satisfied the distribution option described in A-13(A) of this notice with respect to a qualified participant's diversification election for a given year if the qualified participant does not elect to receive a distribution from the plan?

A-15: Yes. An ESOP or a tax credit ESOP has satisfied the diversification of investments requirement with respect to a qualified participant for a given year when the plan has made available to a qualified participant a distribution of the portion of the qualified participant's account subject to the diversification election (as determined under Q&A-9 of this notice) regardless of whether the qualified participant actually elects to receive a distribution of employer securities. Thus, the diversification election has been satisfied where a distribution to a qualified participant has not been made solely because of the failure of a participant to elect such distribution (or of a participant's spouse to consent to the distribution if such consent is required). This result is the same as the result under A-13(B), which requires only that the ESOP offer 3 distinct investment options (and not that a qualified participant actually elect to diversify).

Q-16: To what extent is a distribution of amounts previously diversified pursuant to section 401(a)(28) in accordance with either Q&A-13(B) or Q&A-13(C) subject to certain other provisions of the plan or Code governing distributions?

A-16: Amounts that have been diversified pursuant to section 401(a)(28) in accordance with either Q&A-13(B) or Q&A-13(C) are treated as amounts that are not held under an ESOP. Thus, section 409(h) does not apply to a distribution of such amounts. Similarly, section 411(d)(6) is not violated if such amounts are not available for distribution in the form of employer securities. Finally, in the case of an ESOP that is a money purchase pension plan, amounts that have been previously diversified in accordance with either Q&A-13(B) or Q&A-13(C) may not be distributed prior to the participant's separation from service and fail to qualify for the special ESOP benefit exception under section 401(a)(11)(C).

Q-17: Has an ESOP failed to satisfy the requirements of section 401(a)(28) with respect to diversification elections offered to qualified participants before the issuance of this notice if it offered such elections in accordance with a reasonable interpretation of section 401(a)(28)?

A-17: No. An ESOP which offered diversification elections which do not fully conform with this notice before the issuance of this notice has not failed to satisfy the requirements of section 401(a)(28) where: 1) the non-conforming diversification election was first offered to qualified participants before June 8, 1988, and 2) the non-conforming diversification election was based on a reasonable interpretation of the statute. However, any diversification election offered after June 8, 1988, must be in compliance with the requirements of this notice An ESOP which offered qualified participants a diversification election before June 8, 1988, which did not comply with the requirements of this notice, may offer qualified participants a diversification election which conforms to the requirements of this notice within the period ending on September 6, 1988. For purposes of this provision, operation in conformity with the model plan amendments contained in Notice 87-2, 1987-2 IRB 17, will be treated as based on a reasonable interpretation of the statute.

In addition, a calendar year ESOP which offered, within the first 90 days of 1988, a diversification election to a person who became a qualified participant during the 1987 plan year will be treated as operating on the basis of a reasonable interpretation and therefore has not failed to comply with section 401(a)(28)(B) even though such a participant is not required to be given a diversification election pursuant to the statute until the first 90 days of 1989.

B. Code Section 72(t)

Q-18: For purposes of section 72(t)(2)(C), when have a majority of assets in an ESOP, or benefits distributed to participants, been invested in employer securities for the five plan year period preceding a distribution?

A-18: For purposes of determining whether a plan has had a majority of its assets invested in employer securities (as defined in section 409(1)) for the preceding five plan year period under section 72(t)(2)(C)(i), or for purposes of determining whether a distribution is a "qualifying ESOP distribution" (See Q&A-21 of Notice 87-13) under section 72(t)(2)(C)(ii), assets of the plan will not fail to be treated as invested in employer securities solely because of the transactions described in this Q&A-18.

A) Cash or other assets derived from the disposition of employer securities pursuant to a corporate reorganization or acquisition attempt (whether or not successful) which are used to purchase other employer securities will be treated as invested in employer securities at the time acquired by the plan if the period between the disposition and the reinvestment does not exceed 90 days or such longer period as may be granted by the Commissioner under rules similar to those of Treas. Reg. §1.46-8(e)(10). For dispositions after June 8, 1988, no extensions will be granted unless applied for within 90 days after the disposition.

B) Cash contributions made by the employer to a tax credit ESOP will be treated as invested in employer securities at the time acquired by the plan if such contributions are used to purchase employer securities within the time periods after contribution provided by the applicable statutory or regulatory provisions governing the requirements for the tax credit.

C) Any other contributions made to an ESOP in cash (including employee contributions) will be treated as invested in employer securities at the time acquired by the plan if such contributions are used to purchase employer securities within 60 days after the date of the contribution.

D) Earnings or dividends attributable to employer securities paid in cash to an ESOP will be treated as invested in employer securities at the time acquired by the plan if such earnings or dividends are used to purchase employer securities within 60 days from the date of payment to the ESOP.

E) Proceeds of an exempt loan (under section 4975) received by the ESOP in cash will be treated as invested in employer securities at the time acquired by the plan if such proceeds are invested in employer securities with 60 days of the receipt of the proceeds by the ESOP.

F) Amounts transferred to an ESOP pursuant to a section 4980 transaction will be treated as invested in employer securities at the time acquired by the plan if the amounts are used to purchase employer securities within the time period prescribed in section 4980(c)(3)(B).

In addition, benefits held in cash or cash equivalents are to be treated as invested in employer securities to the extent that the value of such benefits allocated to a participant does not exceed 2 percent of the value of the employer securities allocated to such participant under the ESOP or tax credit ESOP.

Reliance

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

The Depositor Ownership Requirements for Certain Financial Institutions Under Section 382(1)(5)(A) and (F)

Notice 88-57

Section 621(a) of the Tax Reform Act of 1986 (the "Act") amended section 382 of the Internal Revenue Code to provide that, for any taxable year ending after the date on which an ownership change occurs (the "change date"), the amount of a new loss corporation's taxable income that may be offset by any pre-change loss cannot exceed the section 382 limitation for such year. Special rules are provided so that the section 382 limitation on the utilization of pre-change losses will not apply in the case of an ownership change with respect to certain distressed financial institutions. See section 382(1)(5)(A) and (F). The Internal Revenue Service intends to promulgate regulations clarifying the interpretation of these rules.

In general, relief under section 382(1)(5)(A) is available if (i) the old loss corporation is under the jurisdiction of the court in a title 11 or similar case immediately before the ownership change and (ii) the shareholders and creditors of the old loss corporation (determined immediately before the ownership change) own at least 50 percent of the new loss corporation stock immediately after the ownership change (the "continuity of ownership requirement"). Although stock described in section 1504(a)(4) is not treated as stock under section 382, regulations will provide that such stock shall be treated as a creditor's claim against the old loss corporation and the owner of such stock shall be treated as a creditor for purposes of the continuity of ownership requirement.

In the case of a financial institution that undergoes a reorganization described in section 368(a)(3)(D)(ii) or certain other transactions which occur as an integral part of a transaction involving such a reorganization (collectively referred to as "special reorganizations"), section 382(1)(5)(F) provides that (i) the continuity of ownership requirement shall be reduced from 50 percent to 20 percent, (ii) a depositor in the old loss corporation shall be treated as a stockholder in that corporation, and (iii) the deposits of the old loss corporation which become deposits of the new loss corporation shall be treated as stock of the new loss corporation. The cross reference in section 382(1)(5)(F)(i)(I), which modifies the general continuity of ownership requirement in the case of special reorganizations, has created some uncertainty as to how continuity of ownership is satisfied in such cases.

Prior to amendment by the Act, section 382 ("old section 382") provided similar relief to a financial institution that was reorganized in a title 11 or similar case. The continuity of ownership requirement under that provision also required that the owners of the transferor corporation (with the depositors treated as owners) retain at least a 20 percent continuity of ownership in the acquiring corporation in order to avoid a reduction in the transferor corporation's net operating losses. Under old section 382, continuity of ownership did not require the retention of any voting interest in the acquiring corporation, but was measured solely by reference to the fair market value of the interest received in the acquiring corporation by the owners of the transferor corporation.

The legislative history of section 382(1)(5)(F) indicates that Congress did not intend to alter the prior law continuity of ownership requirement for special reorganizations. H. Rep. (Conf. Rep.) No. 99-841, 99th Cong. 2d Sess. 193, 1986-3 C.B. (Vol. 4) 193. Consequently, the Service intends to promulgate regulations under section 382 which will provide that the 20 percent continuity of ownership requirement under section 382(1)(5)(A) and (F) is to be applied by disregarding the voting power requirement of section 1504(a)(2)(A).

Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Defined Benefit Plans Transferring Assets to Defined Contribution Plans

Notice 88-58

This notice provides guidance as to those instances which are excepted from the suspension of determination and examination cases involving transfers of plan assets and liabilities from defined benefit plans to defined contribution plans.

On February 21, 1985, the IRS, with the Department of Labor and the Pension Benefit Guaranty Corporation, cautioned that transfers of funds between plans were subject to the requirements of the Internal Revenue Code and Title I of the Employee Retirement Income Security Act of 1974 (see IR-85-19). Subsequently, on February 18, 1986, the IRS issued a field directive that suspended determination and examination cases with respect to transfers of assets and liabilities from defined benefit plans to defined contribution plans. In the field directive the IRS stated that such transfers would be studied to determine their effect on plan qualification.

As of May 9, 1988, any case involving a terminating defined benefit plan from which only excess assets are transferred to a defined contribution plan of the same employer will be released from the suspension if the termination satisfies all applicable requirements. For purposes of release from the suspension, the transfer may involve amounts that could revert to the employer. Cases in which liabilities of the plan are being transferred will continue to be subject to the suspension.

In order to satisfy all liabilities under the plan, the plan administrator must distribute plan assets by purchasing irrevocable commitments from an insurer to provide all benefits under the plan or by otherwise fully providing all benefits under the plan in accordance with plan provisions and applicable requirements. After satisfaction of all plan liabilities, the remaining assets ("excess assets") may revert to the employer under certain circumstances and to the extent provided in the plan.

For federal income tax purposes (except as provided for under section 4980(c)(3) of the Code), a transfer of excess assets from a defined benefit plan to a defined contribution plan of the same employer constitutes a reversion of the assets to the employer followed by a contribution to the defined contribution plan. Thus, a reversion of excess assets from a defined benefit plan, whether received by the employer or transferred to a defined contribution plan, is included in the gross income of the employer under section 61 of the Internal Revenue Code (subject to the limitations of section 111). In addition, section 4980 of the Code imposes a tax equal to 10% of the amount of any direct or indirect employer reversion from a qualified plan. Section 4980(c)(3) of the Code provides a temporary exception to the inclusion of a reversion in gross income, and also from imposition of the 10% tax on reversions, for any portion of a reversion transferred from a defined benefit plan to an employee stock ownership plan (ESOP), if the transfer meets the requirements set forth in such section.

For the employer maintaining the defined benefit and defined contribution plans involved in such a transfer, any deduction will be subject to the limitations of section 404(a) of the Code, because the employer has made a contribution to the defined contribution plan in an amount equal to the amount transferred. In addition, with respect to any nondeductible contribution, the excise tax imposed by section 4972 of the Code will apply.

Any excess assets transferred from a defined benefit plan to a defined contribution plan and allocated to participants' accounts are annual additions for the limitation year in which allocated under that defined contribution plan and will be subject to the limits of section 415 of the Code (including restrictions on the use of suspense accounts).

Plan administrators who have a ruling request in suspension due to the study of transfer issues but believe that their request should now be released from suspense should contact the appropriate Key District Office.

The Service is still studying other forms of transfers from a defined benefit plan to a defined contribution plan and further guidance is expected to be available shortly.

No inference is intended as to the implications of these transactions under Part 4 of Title I of ERISA.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Applicable Short-Term Federal Rate Under Section 6621

Notice 88-59

In determining the quarterly interest rates to be used for overpayments and underpayments of tax under section 6621 of the Internal Revenue Code, the Internal Revenue Service will use the federal short-term rate based on daily compounding.

Section 6621 of the Code, as amended by the Tax Reform Act of 1986, section 1511, 1986-3 (Vol. 1) C.B. 1, 661, establishes differential rates for computing interest on tax overpayments and underpayments. The overpayment rate equals the sum of the federal short-term rate plus 2 percentage points, and the underpayment rate equals the sum of the federal short-term rate plus the 3 percentage points. For this purpose, the "federal short-term rate" is the federal short-term rate determined in accordance with section 1274(d), rounded to the nearest percent. Under section 6621, the rate effective for a calendar quarter is based on the federal short-term rate determined during the first month of the preceding calendar quarter.

Section 1274(d)(1)(C)(i) of the Code provides that the federal short-term rate shall be the rate determined by the Secretary based on the average market yield (during any one month period selected by the Secretary and ending in the calendar month in which the determination is made) on outstanding marketable obligations of the United States with remaining periods to maturity of 3 years or less.

Section 6622 of the Code provides the general rule that in computing the amount of any interest required to be paid by the Secretary or by the taxpayer, or any other amount determined by reference to the amount of interest, the interest and the amount shall be compounded daily.

Annual, semi-annual, quarterly, and monthly equivalency rates are published monthly for purposes of section 1274(d) of the Code. The statute and committee reports do not specify which federal short-term rate should be used in performing the computations required by section 6621. Because the section 6621 rate is subject to daily compounding under section 6622, the rate most consistent with determination of the section 6621 rate is the federal short-term rate based on a daily compounding assumption.

In addition, the daily compounding rate is the rate that most accurately reflects the cost to the government of borrowing funds that are unavailable because of tax delinquencies.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Foreign Life Insurance Companies—Percentage

Notice 88-60

AGENCY: Department of the Treasury.

ACTION: Proclamation.

SUMMARY: This proclamation announces the percentage to be used to compute the income tax liability for 1987 of foreign corporations carrying on life insurance business in the United States and provides instructions for computing the estimated tax and the installment payments of estimated tax for 1988 for all foreign insurance companies.

EFFECTIVE DATE: March 15, 1988.

SUPPLEMENTARY INFORMATION: This proclamation, issued each year by the Secretary of the Treasury, announces the percentage to be used to compute the income tax liability of foreign corporations carrying on life insurance business in the United States. In addition, the proclamation provides instructions for computing the estimated tax and the installment payments of estimated tax for 1988 for all foreign insurance companies.

PROCLAMATION

For purposes of computing the 1987 income tax of foreign corporations carrying on a life insurance business, a percentage of 16.2 percent shall be used in determining the "minimum figure" under former section 813. For purposes of computing the estimated tax and the installment payments of estimated tax for the taxable year 1988, all foreign insurance companies (life and property-casualty companies) will be allowed to rely on their actual investment income for purposes of computing investment income under section 842, as amended by the Omnibus Budget Reconciliation Act of 1987, until publication by the Secretary of the domestic asset/liability percentages and the domestic investment yields under section 842. No additions to tax shall be made because of any underpayment of estimated tax for the taxable year 1988 if: (1) The taxpayer timely pays estimated tax based on its actual net investment income, and (2) the taxpayer deposits the full amount due under section 6655 of the Code with its first estimated tax payment following publication of the domestic asset/liability percentages and the domestic investment yields under section 842.

This proclamation was issued without notice and public procedure because the public cannot effectively participate in the determination of the percentage required under former section 813. It is computed from information contained in income tax returns that are not open to the public. The proclamation was not published prior to its effective date because the percentage is computed on the basis of data which was not then available.

O. Donald Chapoton,
Assistant Secretary (Tax Policy).

(Filed by the Office of the Federal Register on April 13, 1988, 8:45 a.m., and published in the issue of the Federal Register for April 14, 1988, 53 F.R. 12493)

List of Countries Requiring Cooperation with an International Boycott

Notice 88-61

In order to comply with the mandate of section 999(a)(3) of the Internal Revenue Code of 1954, the Department of the Treasury is publishing a current list of countries which may require participation in, or cooperation with, an international boycott (within the meaning of section 999(b)(3) of the Internal Revenue Code of 1954). The list is the same as the prior quarterly list published in the **Federal Register**.

On the basis of the best information currently available to the Department of the Treasury, the following countries may require participation in, or cooperation with, an international boycott (within the meaning of section 999(b)(3) of the Internal Revenue Code of 1954).

Bahrain
Iraq
Jordan
Kuwait
Lebanon
Libya
Oman
Qatar
Saudi Arabia
Syria
United Arab Emirates
Yemen, Arab Republic
Yemen, Peoples Democratic Republic of

Date: March 24, 1988.

O. Donaldson Chapoton,
Assistant Secretary for Tax Policy.

(Filed by the Office of the Federal Register on March 29, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 30, 1988, 53 F.R. 10326)

Application of Uniform Capitalization Rules to Authors and Other Producers of "Creative Properties"

Notice 88-62

This notice provides guidance to certain authors, photographers, artists, and other similarly situated persons regarding the uniform capitalization rules under section 263A of the Internal Revenue Code.

I. Background.

Section 263A of the Code, enacted in the Tax Reform Act of 1986 (Pub. L. 99-514, the "1986 Act"), provides uniform capitalization rules that govern the treatment of costs incurred in the production of property or the acquisition of property for resale. Section 263A was enacted, in part, to prevent the inappropriate mismatching of income and expense that resulted from the current deduction of the costs of producing or acquiring property.

Section 263A(b) of the Code generally provides that the uniform capitalization rules apply to the "production" (including the development or improvement) of real or tangible personal property produced by the taxpayer. Moreover, this section provides that, for purposes of the uniform capitalization rules, the term "tangible personal property" shall include a film, sound recording, video tape, book, or similar property. (See also the legislative history to section 263A contained in 2 H.R. Rep. No. 99-841 (Conf. Rep.), 99th Cong., 2d Sess. II-308, n. 1 (1986)). Based on section 263A(b) and its accompanying legislative history, section 1.263A-1T (a)(5)(iii) of the regulations provides, for example, that section 263A requires the capitalization by authors of the costs of researching, preparing and writing literary works. Similar rules apply to the production of other properties enumerated as tangible properties in section 263A(b).

For example, costs required to be capitalized under section 263A by authors and other similar persons consist of the costs of creating, researching, writing and preparing the literary works and other properties being produced, including costs of travel undertaken for business purposes (*e.g.*, research); depreciation, rent and repairs on equipment and facilities used in producing the properties; all labor and compensation costs (including pension costs, where applicable) of any persons involved in the production activity; office overhead; interest (where required under section 263A(f)); and any other direct or indirect costs relating to the production of such properties as described in 1.263A-1T(b)(2) of the regulations.

Taxpayers are required to allocate and capitalize costs to the particular properties being produced, and to recover such costs under other applicable provisions of the Code. *See, e.g.*, section 167 (depreciation); Rev. Rul. 60-358, 1960-2 C.B. 68, *Siegel v. Commissioner*, 78 T.C. 659 (1982) (income forecast method); section 1.61-3(a) of the regulations (cost of goods sold).

II. Authority and Need for Safe Harbor.

The Internal Revenue Service has received numerous inquiries from authors, photographers and other persons expressing concern regarding the application of the uniform capitalization rules to their businesses. These concerns have focused both on the allocation and capitalization of costs under section 263A, as well as the amortization or recovery of these capitalized costs under other sections of the Code.

The legislative history of section 263A indicates that Congress was aware of the possible administrative complexities resulting from the application of the uniform capitalization rules to businesses. In response to this concern, Congress granted the Treasury Department authority under section 263A to "adopt other simplifying methods and assumptions where, in the judgment of the Secretary of the Treasury, the costs and other burdens of literal compliance may outweigh the benefits." S. Rep. 99-313, 99th Cong., 2d Sess. 141-42 (1986).

Moreover, in the preamble to temporary regulations under section 263A, published in the Federal Register on March 30, 1987 (52 FR 10057, T.D. 8131), the Internal Revenue Service generally solicited comments and suggestions regarding the use of simplified methods in complying with the uniform capitalization rules under section 263A. In response to this request for comments, the Internal Revenue Service has received numerous suggestions from taxpayers asking that additional simplified methods be provided for individual authors, photographers, and other taxpayers creating various types of property.

III. Elective Safe Harbor—In General.

Based on the foregoing, this notice provides an elective three-year "safe harbor" for certain authors and other taxpayers with respect to their capitalization of costs under section 263A and the recovery or amortization of such costs under other sections of the Code.

Under the three-year safe harbor provided herein, taxpayers shall aggregate and capitalize all "qualified creative costs" incurred during each taxable year and shall amortize and deduct 50 percent of such aggregate costs in the year they are incurred, 25 percent of such costs in the year following the year in which they are incurred, and the final 25 percent of such costs in the second year following the year in which they are incurred.

The three-year safe harbor provided in this notice substantially reduces the administrative complexities of complying with the uniform capitalization rules by eliminating the necessity to amortize the capitalized costs under the income forecast method for taxpayers otherwise required to use such method. (The income forecast method requires the taxpayer to estimate the future expected income to be received from the property in issue, in addition to only allowing the taxpayer to amortize the property's capitalized costs for the periods during which the taxpayer recognizes income from such property).

Moreover, the three-year safe harbor provided here eliminates any need for the taxpayer to allocate total costs incurred in the taxpayer's trade or business between (i) costs that are required to be capitalized under section 263A and costs that are permitted to be expensed; and (ii) costs incurred with respect to separate properties produced by the taxpayer (*e.g.*, various manuscripts being created by an author). It is anticipated that the 50 percent portion of total aggregate qualified creative costs deducted in the year such costs are incurred under the safe harbor, reasonably approximates the amounts of both otherwise deductible costs incurred during that taxable year and the amortization of costs required to be capitalized under section 263A for that year.

IV. Properties Covered By Safe Harbor.

This three-year safe harbor is available only for the qualified creative costs paid or incurred ("incurred") in producing "creative properties" defined as films, sound recordings, video tapes, books (including, for example, articles and poems), photographs, plays and other dramatic works, musical and dance compositions (including accompanying words), graphic and pictorial compositions, fine art paintings and sculptures, and other similar fine art products (but not including jewelry).

No other properties other than those defined herein as creative properties are eligible for this safe harbor. For example, section 263A is itself applicable, in part, to the production of a film, sound recording, video tape, book or "similar property." The term "similar property" in section 263A is not limited to properties which are defined as creative properties in this notice. Thus, the term "similar property" in section 263A may include specific types of properties other than, and in addition to, the properties defined herein as being eligible for the three-year safe harbor. Similarly, certain properties (*e.g.*, paintings and sculptures) defined as creative properties for purposes of this notice are tangible properties and hence subject to the capitalization rules of section 263A without reference to the provisions of section 263A(b) providing that certain enumerated properties shall be treated as tangible for purposes of the uniform capitalization rules.

Taxpayers electing to use the three-year safe harbor in accounting for the costs of producing any creative property to which this three-year safe harbor applies shall be deemed to have also elected to use the three-year safe harbor in accounting for the production of any other creative property to which the safe harbor applies. Thus, for example, a taxpayer producing both books and films who elects to use the three-year safe harbor in accounting for the production of the books must also use the three-year safe harbor with respect to the production of the films.

V. Qualified Creative Costs—In General.

The three-year safe harbor provided herein only applies to "qualified creative costs" which are defined as certain costs incurred by a self-employed individual (except as provided in section VIII herein), in the production of creative properties where the personal efforts of such individual predominantly create such properties. Qualified creative costs do not include the costs paid or incurred by a person in his capacity as an employee, nor do they include costs incurred by an individual in producing creative properties where the personal efforts of such individual do not predominantly create such properties (*e.g.*, where the properties are predominantly created by persons other than the individual such as employees or independent contractors).

With respect to any properties predominantly created by employees of the individual or by independent contractors hired by the individual, the provisions of this safe harbor are not available in accounting for the costs of producing such properties under section 263A. (Qualified creative costs do, however, include amounts paid by an individual to employees or independent contractors assisting in the production of the creative properties, if the personal efforts of such individual predominantly create such properties.)

Moreover, except as provided in section VIII herein, qualified creative costs do not include costs incurred by any person other than an individual. For example, except as provided in section VIII, qualified creative costs do not include costs incurred by a partnership, trust, or corporation.

For purposes of the three-year safe harbor, qualified creative costs consist of all costs incurred by the taxpayer in the trade or business or activity conducted for profit (collectively, "trade or business") of producing creative properties that would be otherwise deductible under the Internal Revenue Code of 1986, excluding the provisions of section 263A. Thus, qualified creative costs consist of: (i) all costs required to be capitalized under section 263A and the regulations thereunder with respect to the production of creative properties ("section 263A costs"); and (ii) all other costs incurred and otherwise deductible by the taxpayer in the trade or business of producing creative properties.

VI. Qualified Creative Costs—Examples.

Qualified creative costs eligible for this safe harbor would generally include, for example, depreciation deductions taken with respect to a computer or automobile (*i.e.*, equipment and facilities) used to produce creative properties, since these costs are required to be capitalized under section 263A as a cost of producing such properties. In contrast, qualified creative costs would not include the costs of purchasing a computer or an automobile that will be used to produce creative properties because, although such purchase costs are capitalized (*see, e.g.*, section 263), they are not capitalized under section 263A as costs of producing creative properties. Moreover, such costs are not otherwise deductible by the taxpayer.

Qualified creative costs also include all other costs incurred by the taxpayer that would be otherwise deductible in the trade or business of producing creative properties. Thus, such costs include the costs of marketing, selling, advertising and distributing creative properties undertaken by an individual in the trade or business of producing creative properties. For example, costs incurred by a taxpayer in promoting or selling a finished manuscript or photograph would be qualified creative costs and thus would be subject to the provisions of this three-year safe harbor. In addition, qualified creative costs include all office overhead (*e.g.*, general and administrative costs), and all otherwise deductible interest expense incurred in the trade or business of producing creative properties, regardless of whether such costs would be required to be capitalized under section 263A.

Moreover, qualified creative costs include the costs of producing properties that are sold (or otherwise disposed of, in their entirety) by the taxpayer in the same taxable year that such costs are incurred. For example, costs incurred by a taxpayer in writing an article (or producing a photograph) that the taxpayer sells in its entirety to a magazine in the same year that the costs are incurred would be qualified creative costs and thus would be subject to this three-year safe harbor.

Similarly, costs incurred by a taxpayer in a hobby are not qualified creative costs eligible for this safe harbor because (i) such costs are not section 263A costs; and (ii) qualified creative costs only consist of costs incurred in a trade or business or an activity conducted for profit.

VII. Mechanics of Three-Year Safe Harbor.

Assume, for example, that a photographer elects to use the three-year safe harbor beginning in 1987 when the taxpayer incurs a total of $16,000 in qualified creative costs consisting of all the taxpayer's section 263A costs, and all other costs incurred that year in the photography business that would be otherwise deductible by the taxpayer. Under the three-year safe harbor, the photographer would capitalize $16,000 of costs in 1987 and would expense $8,000 of these costs in 1987, and $4,000 of these costs in each of 1988 and 1989. In addition, assume that the photographer incurs a total of $20,000 in qualified creative costs in 1988. The photographer would capitalize $20,000 of costs in 1988 and would expense $10,000 of these costs in 1988, and $5,000 of these costs in each of 1989 and 1990.

VIII. Availability of Safe-Harbor to Certain Entities.

The three-year safe harbor may be used with respect to a corporation or partnership engaged in the trade or business of producing creative properties (an "eligible corporation" or "eligible partnership"), but only if the requirements of this section VIII are met. A corporation or partnership may use the three-year safe harbor if substantially all of such entity is owned by one "qualified employee owner", as defined herein. For purposes of this provision, ownership by any members of such qualified employee owner's family, as defined in section 267(c)(4) of the Code, shall be treated as ownership by the qualified employee owner.

A qualified employee owner shall be deemed to own substantially all of a corporation if such individual owns at least 95 percent (by value) of the stock of such corporation. Similarly, a qualified employee owner shall be deemed to own substantially all of a partnership if such individual has an interest in partnership profits and capital of at least 95 percent.

A qualified employee owner is an individual employed by an eligible corporation or eligible partnership where the personal efforts of such qualified employee owner produce creative properties for such corporation or partnership. Moreover, "qualified creative costs" eligible for this safe harbor only include costs incurred in the production of creative properties where the personal efforts of the qualified employee owner predominantly create such properties. Qualified creative costs do not include any of the costs of creating properties where the personal efforts of the qualified employee owner do not predominantly create such properties (*e.g.*, where the properties are predominantly created by persons other than the qualified employee owner such as other employees or independent contractors). With respect to any properties predominantly created by persons other than the qualified employee owner, the provisions of this safe harbor are not available in accounting for the costs of producing such properties under section 263A.

Any corporation or partnership meeting the requirements of this section VIII may use the three-year safe harbor provided in this notice in accounting for qualified creative costs, subject to all the requirements, conditions and procedures of this notice applicable to individuals electing such safe harbor (except where expressly noted).

IX. Election to Use Three-Year Safe Harbor

Taxpayers may automatically elect to use the three-year safe harbor by determining and reporting their taxable income under such safe harbor on a timely filed (with regard to extensions) Federal income tax return for the first taxable year (including, but not limited to the first taxable year ending after December 31, 1986) to which the provisions of section 263A apply to the particular taxpayer's production of creative properties.

In addition, with respect to the taxpayer's first taxable ending after December 31, 1986 (typically, the calendar 1987 year), taxpayers may automatically elect to use the three-year safe harbor by determining and reporting their taxable income under the safe harbor on an amended Federal income tax return for such year filed within 270 days after this notice is published in the Internal Revenue Bulletin.

Alternatively, eligible taxpayers who have filed, on or before [date which is thirty days after publication of this notice in the Internal Revenue Bulletin] a Federal income tax return for their first taxable year ending after December 31, 1986, may, if those taxpayers choose, follow the procedures set forth herein (the "1988 election") and automatically adopt the three-year safe harbor for their first taxable year ending after December 31, 1987 (typically, the calendar year 1988). By adopting the 1988 election, taxpayers wishing to use the three-year safe harbor may, if they choose, avoid filing an amended return for their first taxable year ending after December 31, 1986.

Taxpayers are eligible to adopt the 1988 election if, and only if, such taxpayers have properly capitalized the costs of producing creative properties for their first taxable year ending after December 31, 1986, as required by section 263A and the regulations thereunder. Taxpayers who have not properly capitalized their costs of producing creative properties in determining and reporting taxable income on a Federal income tax return filed for their first taxable year ending after December 31, 1986, may not adopt the 1988 election. Such taxpayers may only elect to use the three-year safe harbor by filing an amended return using the three-year safe harbor for their first taxable year ending after December 31, 1986, as described in this section IX.

Taxpayer properly adopting the 1988 election shall take the balance of section 263A capitalized costs, outstanding on their books and records as of the close of their first taxable year ending after December 31, 1986, and shall amortize and deduct 50 percent of such capitalized costs in their first taxable year ending after December 31, 1987, and 50 percent of such costs in the next succeeding taxable year. Such taxpayers shall also apply the three-year safe harbor to qualified creative costs incurred in their first taxable year ending after December 31, 1987, and for all years thereafter.

For example, assume a calendar year taxpayer producing creative properties properly capitalizes the costs of producing such creative properties in determining and reporting taxable income in a 1987 Federal income tax return that is filed on April 15, 1988. The taxpayer has a balance of $12,000 in outstanding section 263A costs on her books and records as of December 31, 1987, *i.e.*, the taxpayer has capitalized, as a cost of producing creative properties, $12,000 of costs in 1987 that have not been amortized or deducted as of the close of the taxable year. The taxpayer may adopt the three-year safe harbor by filing an amended return for 1987 using the three-year safe harbor for that year. Thus, the taxpayer would determine all of the qualified creative costs (including, but not limited to, section 263A costs) incurred in 1987 and apply the three-year safe harbor to those costs and to all qualified creative costs incurred in subsequent years.

Alternatively, the taxpayer may, if she chooses, adopt the 1988 election and, with respect to the $12,000 balance of section 263A costs outstanding at December 31, 1987, amortize and deduct $6,000 of those costs in 1988, and $6,000 of those costs in 1989. The taxpayer would then apply the three-year safe harbor to all qualified creative costs incurred in 1988 and in all subsequent years. Thus, if the taxpayer incurs an additional $18,000 of qualified creative costs in 1988, the total costs deducted in 1988 would be $15,000 ($6,000 + $9,000); the total costs deducted in 1989 would be $10,500 ($6,000 + 4,500), in addition to 50% of the qualified creative costs incurred in 1989. The taxpayer would file a Federal income tax return for 1988 determining and reporting taxable income under these procedures. The taxpayer would not file an amended return for 1987.

Taxpayers automatically electing to use the three-year safe harbor on a Federal income tax return (whether such return is timely filed or is amended, and regardless of whether the 1988 election is adopted) shall note such election of the safe harbor by typing or legibly printing the following statement at the top of page 1 of Schedule C (Form 1040): "Three-Year Safe Harbor Adopted Under the Provisions of Notice 88-62." With respect to corporations and partnerships automatically electing to use the three-year safe harbor, such statement shall be provided on the top of Schedule A, Form 1120, or Schedule A, Form 1065, respectively.

Except as otherwise provided in this notice, taxpayers may not elect the use of the three-year safe harbor for any taxable year, unless consent to such change in method of accounting is obtained from the Commissioner. Moreover, taxpayers electing to use this three-year safe harbor may not discontinue such use unless consent to such change in method of accounting is obtained from the Commissioner.

Procedural Information.

This notice serves as an "administrative pronouncement" as that term is described in section 1.6661-(3)(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

Applicable Rate of Interest on Nonqualified Withdrawals From a Capital Construction Fund

Notice 88-63

Under the authority in section 607(h)(4)(B) of the Merchant Marine Act, 1936, as amended (46 U.S.C. 1177(h)(4)(B)), we hereby determine and announce that the applicable rate of interest on the amount of additional tax attributable to any nonqualified withdrawals from a Capital Construction Fund established under section 607 of the Act shall be 8.00 percent, with respect to nonqualified withdrawals made in the taxable year beginning in 1987.

The determination of the applicable rate of interest with respect to nonqualified withdrawals was computed, according to the joint regulations issued under the Act (46 CFR 391.7(e)(2)(ii)), by multiplying eight percent by the ratio which: (1) The average yield on 5-year Treasury securities for the calendar year immediately preceding the beginning of such taxable year bears to (b) the average yield on 5-year Treasury securities for the calendar year 1970. The applicable rate so determined was computed to the nearest one-hundredth of one percent.

Dated: April 29, 1988.

So Ordered by. Maritime Administrator, Maritime Administration; Administrator, National Oceanic and Atmospheric Administration; Assistant Secretary for Tax Policy, Department of the Treasury.

E. L. Chao
Maritime
Administrator.

J. Curtis Maek, II,
Acting Administrator,
National Oceanic and
Atmospheric
Administration.

O. Donaldson Chapoton,
Assistant Secretary for
Tax Policy.

(Filed by the Office of the Federal Register on May 5, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 6, 1988, 53 F.R. 16332).

Inflation Adjustment for Computation of Windfall Profit Tax

Notice 88-64

Section 4989(b) of the Internal Revenue Code requires the determination of an inflation adjustment factor for use in computing the windfall profit tax.

The Service has determined that, for oil removed during the July-September quarter of 1988, the inflation adjustments are as follows:

Tier 1 or Tier 2 oil	0.5321
Tier 3 oil	0.8244

Worksheets for computation of the windfall profit tax are included in the Instructions for Form 6047, Windfall Profit Tax, and an explanation of the inflation adjustment may be found in the Specific Instructions for Line 4 of the worksheets.

Filing Requirements for Returns Claiming the Foreign Tax Credit

Notice 88-65

Section 1.905-2 of the Income Tax Regulations sets forth conditions for allowance of the foreign tax credit available under section 901 of the Internal Revenue code of 1986. To claim the credit, individuals must submit Form 1116, and corporations must submit Form 1118.

Section 1.905-2(a)(2) of the regulations requires taxpayers to attach to the return a receipt for taxes paid, and a foreign tax return for taxes accrued. Section 1.905-2(b) describes secondary evidence of taxes paid or accrued that may be submitted in lieu of these documents. Recent efforts by the Service to enforce this requirement have revealed that many taxpayers cannot timely obtain and prepare the necessary information in a form suitable for submission with the tax return.

Therefore, the Service is initiating an effort to analyze compliance levels for foreign tax credits and will study the current system for claiming foreign tax credits and explore alternative systems. In conjunction with the study, regulations will be issued suspending all but the first sentence of section 1.905-2(a)(2) of the regulations, and all of section 1.905-2(b). The suspension will be effective beginning January 1, 1988.

Taxpayers whose 1987 returns have been rejected by the Service for lack of foreign tax credit documentation must resubmit those returns on or before August 15, 1988, accompanied by the Form 3531 they received. If Form 3531 is missing, the resubmitted return must be accompanied by a supplemental statement attesting to the date the return was originally submitted. No other documentation need be submitted. Taxpayers who have already resubmitted returns without Form 3531 need not resubmit again. Returns that were originally timely submitted and that are resubmitted as described in this paragraph will be deemed for all purposes as filed on the date of original submission.

Taxpayers whose returns have been retained, but who have received letters from the Service requesting foreign tax credit documentation, need not respond to those letters.

The Service will not assess late filing penalties if an otherwise timely return was rejected solely for lack of foreign tax credit documentation and the return is timely resubmitted as described above. A taxpayer who receives a notice of assessment of such a penalty may apply for abatement by submitting to the Service a statement attesting that the return was timely submitted and referring to this notice.

The Service cautions that foreign tax credits, like all other items on the return, must be substantiated with proper documentation, and that the documentation must be available for examination on request. *See* Rev. Rul. 67-308, 1967-2 C.B. 254. The suspension of the regulations means only that until further notice, the documentation need not be submitted when the return is filed.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied on to the same extent as a revenue ruling or revenue procedure.

Long-term Contracts; Modification of the Percentage of Completion-Capitalized Cost Method

Notice 88-66

This notice provides guidance with respect to the amendment of section 460 of the Internal Revenue Code, regarding the accounting for long-term contracts, by section 10203 of the Revenue Act of 1987 (the "1987 Act"), Pub. L. No. 100-203, 101 Stat. 1330. This notice amplifies the provisions of Notice 87-61, 1987-2 C.B. 370. This notice and Notice 87-61 relate to the procedures by which taxpayers may change their methods of accounting for long-term contracts for purposes of section 460 of the Code. As a result of the amendment of section 460 of the Code by the 1987 Act, certain taxpayers may wish to reconsider whether it is desirable to change their method of accounting for long-term contracts. Thus, in addition to providing guidance under section 460 of the Code, the provisions of this notice extend the period of time provided in Notice 87-61 during which taxpayers may automatically change to the percentage of completion method of accounting as modified by section 460 of the Code ("the percentage of completion method") for all long-term contracts entered into after February 28, 1986.

1. *Background.*

Section 460 of the Code provides that, in the case of a long-term contract (except as provided in section 460(e) of the Code), items are to be taken into account using (i) the percentage of completion-capitalized cost method, or (ii) the percentage of completion method. Section 460 is effective for long-term contracts entered into by the taxpayer after February 28, 1986.

As initially enacted, section 460 of the Code required that, under the percentage of completion-capitalized cost method of accounting for long-term contracts, 40 percent of the items with respect to each contract are to be taken into account using the percentage of completion method, and 60 percent of the items with respect to each contract are to be taken into account using the taxpayer's "normal" method of accounting for long-term contracts, subject to the requirements of section 460, including the cost allocation requirements of section 460(c). Section 10203 of the 1987 Act modified the percentage of completion-capitalized cost method to require that, for contracts entered into after October 13, 1987 (with certain exceptions contained in section 10203(b)(2) of the 1987 Act), 70 percent of the items with respect to each contract are to be taken into account using the percentage of completion method and the remaining 30 percent are to be taken into account using the taxpayer's "normal" method, subject to the requirements of section 460, including the cost allocation requirements of section 460(c). For purposes of section 460, a taxpayer's normal method of accounting for long-term contracts is the method the taxpayer was using to account for long-term contracts immediately prior to the effective date of section 460.

Any taxpayer that, immediately prior to the effective date of section 460, accounted for contracts based on the position that such contracts were long-term contracts under section 1.451-3(b) of the Income Tax Regulations, shall be required to account for such contracts (and any successor contracts) under section 460 unless such taxpayer obtains the consent of the Commissioner to change its method of accounting. The term "successor contracts", as used in the preceding sentence, shall mean all contracts which, under the criteria and methods used by the taxpayer prior to the effective date of section 460 in determining whether a contract was a long-term contract under section 1.451-3(b) of the Regulations, would be classified by such taxpayer as long-term contracts under section 1.451-3(b), regardless of whether such criteria and methods are correct. Thus, for example, the criteria and methods used by a taxpayer in determining that items were "unique" prior to February 28, 1986, and thus were produced under long-term contracts, will continue to be used by the taxpayer unless the taxpayer obtains the consent of the Commissioner to change its method of accounting under the applicable administrative procedures in effect at the time of change (*e.g.*, Rev. Proc. 84-74, 1984-2 C.B. 736). See H.R. Rep. No. 495, 100th Cong., 2d Sess. 923 (1987).

II. *Taxpayers Using the Percentage of Completion-Capitalized Cost Method.*

Except as provided in Notice 87-61, any taxpayer reporting income from long-term contracts immediately prior to the effective date of section 460 using a method of accounting other than the percentage of completion method is required to use the percentage of completion-capitalized cost method of accounting for all long-term contracts entered into by the taxpayer after February 28, 1986.

For contracts entered into after February 28, 1986, and before October 14, 1987, the percentage of completion-capitalized cost method requires that 40 percent of the items with respect to each contract be taken into account using the percentage of completion method, and the remaining 60 percent be taken into account using the taxpayer's normal method of accounting for long-term contracts. For contracts entered into after October 13, 1987, the percentage of completion-capitalized cost method requires that 70 percent of the items with respect to each contract be taken into account using the percentage of completion method and that the remaining 30 percent be taken into account using the taxpayer's normal method of accounting for long-term contracts. (However, see section III, relating to automatic changes to the percentage of completion method.)

The change in the percentage of completion-capitalized cost method shall be effectuated by using a "cut-off" method with respect to contracts entered into after October 13, 1987, *i.e.*, the taxpayer shall not change its method of accounting for contracts entered into on or before October 13, 1987 and no adjustment under section 481(a) of the Code shall be computed. Taxpayers described in this section II using the percentage of completion-capitalized cost method of accounting for long-term contracts shall follow the notification procedures of section V of this notice.

III. *Automatic Change to Percentage of Completion Method.*

For purposes of section 460 of the Code, any taxpayer using a method of accounting other than the percentage of completion method as its normal method of accounting for long-term contracts (*e.g.*, a taxpayer using the completed contract, cash or an accrual method of accounting) may automatically change its method of accounting to the percentage of completion method (including, if elected, the simplified cost-to-cost method provided in Notice 87-61) either for—

1) all items under all long-term contracts entered into by the taxpayer after October 13, 1987, or

2) all items under all long-term contracts entered into by the taxpayer after February 28, 1986.

Thus, a taxpayer may use the percentage of completion-capitalized cost method for all contracts entered into after February 28, 1986 and before October 14, 1987, and may, under the terms of this notice, automatically change its method of accounting to the percentage of completion method for all items under all contracts entered into after October 13, 1987. Alternatively a taxpayer may, under the terms of this notice, use the percentage of completion method for all items under all long-term contracts entered into after February 28, 1986. (The effect of alternative (2) of this section III regarding contracts entered into after February 28, 1986 is to extend the period, initially set forth in Notice 87-61, within which taxpayers may elect to use the percentage of completion method for all such contracts.)

The period for filing amended returns for taxpayers changing their method of accounting to the percentage of completion method is provided in section V of this notice. See also section VI of this notice which permits taxpayers to elect whether to include contracts described in section 460(e)(1) of the Code in a change in method of accounting under this section III. Any taxpayer described in this section III shall follow the notification procedures of section V of this notice.

IV. *Changes in Method of Accounting Requiring Commissioner's Consent.*

A change in method of accounting to the percentage of completion method other than a change for—

1) all items under all long-term contracts entered into by the taxpayer after October 13, 1987, or

2) all items under all long-term contracts entered into by the taxpayer after February 28, 1986, will constitute a change in method of account-

ing that requires the consent of the Commissioner. For example, if a calendar year taxpayer wishes to change to the percentage of completion method from the percentage of completion-capitalized cost method for its taxable year beginning on January 1, 1988, such taxpayer is required to obtain the consent of the Commissioner with respect to such change in method of accounting (including the calculation of the resulting section 481(a) adjustment). Prior to obtaining such consent, the taxpayer is required to account for all long-term contracts entered into after February 28, 1986, under section 460 of the Code using a "cut-off" method as provided in this notice and Notice 87-61.

V. *Notification Procedures for Certain Methods of Accounting.*

Any taxpayer described in section II or III of this notice shall complete and file a statement notifying the Service of its use of the various methods of accounting (including the simplified cost-to-cost method provided in Notice 87-61) permitted under this notice with the taxpayer's Federal income tax return for the first taxable year ending after October 13, 1987, for which the taxpayer is required to account under section 460 for long-term contracts. The taxpayer shall type or legibly print the following language at the top of the statement required to be filed: "NOTIFICATION PROCEDURES UNDER SECTION V OF NOTICE 88-66". Any amended return filed by a taxpayer described in section III for the purpose, in whole or in part, of changing a taxpayer's method of accounting as described in this notice must be filed on or before 180 days after the date that this notice is published in the Internal Revenue Bulletin. The taxpayer shall type or legibly print the following language at the top of each amended return: "NOTIFICATION PROCEDURES UNDER SECTION V OF NOTICE 88-66".

Notwithstanding the requirements of the preceding paragraph, with respect to any taxpayer who has (i) filed a Federal income tax return on which the statement described in the preceding paragraph was required to be included, (ii) failed to file the statement described in the preceding paragraph with such return, and (iii) otherwise properly used the method of accounting as required or allowed under sections II or III of this notice, such taxpayer may file a statement indicating the use of its method of accounting under the following procedures. Such statement shall be attached to the taxpayer's first Federal income tax return filed subsequent to 90 days after the publication of this notice in the Internal Revenue Bulletin for which the taxpayer is required to account under section 460 for long-term contracts. (A taxpayer, at its option, may attach such a statement with a return filed before the date described in the preceding sentence.) The taxpayer shall type or legibly print the following language at the top of the statement required to be filed: "NOTIFICATION PROCEDURES UNDER SECTION V OF NOTICE 88-66". Any use of a method of accounting described in this section V shall be effectuated by using a "cut-off" method with respect to contracts entered into after February 28, 1986, or October 13, 1987, as the case may be, *i.e.*, the taxpayer shall not compute a section 481(a) adjustment with respect to its use of the new method of accounting.

VI. *Certain Construction Contracts.*

With the exception of the interest capitalization requirements of section 460(c)(3) of the Code, section 460 does not apply to any contract for the construction of real property entered into by a taxpayer if (i) the taxpayer reasonably estimates (at the time the contract is entered into) that the contract will be completed within the 2-year period beginning on the contract commencement date; and (ii) the taxpayer's average annual gross receipts for the 3 taxable years preceding the taxable year in which the contract is entered into do not exceed $10 million. See section 460(e)(1) of the Code.

However, a taxpayer that wishes to change its method of accounting to the percentage of completion method for all items under all long-term contracts, including long-term contracts described in section 460(e)(1), may make such change in method of accounting under section III of this Notice 88-66. In addition, a taxpayer that makes such change may also elect to use the simplified cost-to-cost method, as provided in Notice 87-61. Alternatively, such a taxpayer may make a change in method of accounting under section III of this notice with respect only to long-term contracts not described in section 460(e)(1), thus retaining its previous method of accounting for contracts described in section 460(e)(1).

Moreover, in applying section 56(a)(3) to determine alternative minimum taxable income with respect to contracts described in section 460(e)(1), a taxpayer may elect to use the simplified cost-to-cost method as provided in Notice 87-61. The preceding sentence liberalizes the provisions of section IX of Notice 87-61, which allowed such an election to be made only by taxpayers properly using the cash method of accounting for long-term contracts.

Thus, for example, assume a taxpayer (taxpayer B) is in the business of constructing and selling houses. Customers enter into contracts with B to purchase the houses, with such contracts typically providing that such purchase shall be consummated after the construction of the house is completed, and after certain other events have occurred (*e.g.*, financing for the house is obtained). Under these facts, B is treated as constructing property under a long-term contract (as defined in section 460(f)) with respect to any house that is under construction as of the end of a taxable year and for which a contract for sale of such house is in effect.

Thus, if B meets the requirements of section 460(e)(1) of the Code, section 460 (except for the interest capitalization requirements of section 460(c)(3)) does not apply to B's long-term contracts. Similarly, section 263A does not apply to the construction of such homes. (See section 263A(c)(4) of the Code.) However, as discussed in Notice 87-61, under the alternative minimum tax ("AMT"), B is required to account for all long-term contracts using the percentage of completion method even though the contracts are exempted under section 460(e)(1) from the percentage of completion method for regular tax purposes. Under this Notice 88-66, B may use the simplified cost-to-cost method of applying the percentage of completion method for AMT purposes, regardless of B's method of accounting for long-term contracts for regular tax purposes.

In contrast, assume that B does not meet the requirements of section 460(e)(1) (*e.g.*, B's average annual gross receipts under section 460(e)(1)(B) exceed $10,000,000). Thus, the requirements of section 460 (including, for example, the use of the look-back method and the percentage of completion method) would apply to B's long-term contracts. As section IX of Notice 87-61 provides, B is allowed to use the simplified cost-to-cost method of applying the percentage of completion method for AMT purposes only if B uses the simplified cost-to-cost method for regular tax purposes. Finally, assume that B has houses under construction as of the end of a taxable year and that no contracts with customers have been entered into for the sale of such houses. With respect to these houses, B is not producing property under a long-term contract because no such contracts exist. Instead, B is constructing property subject to section 263A which, in contrast to section 460(e)(1), does not contain any exceptions for construction contracts under its provisions.

PROCEDURAL INFORMATION

This notice serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or a revenue procedure.

The collection of information in this notice has been submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1980 and has been approved by OMB (Control Number 1545-1011).

Application of the Rule of Section 382(l)(3)(A)(iv) to Convertible Stock

Notice 88-67

The Internal Revenue Service intends to amend the temporary Income Tax Regulations under section 382 of the Internal Revenue Code to, among other things, (i) clarify that certain convertible stock constitutes an "interest that is similar to an option" within the meaning of section 1.382-2T(h)(4)(v)(A), (ii) provide that such an instrument does not constitute "stock" for the purpose of testing whether an ownership change has occurred if, at the time the instrument is issued, it would be described in section 1504(a)(4) by disregarding subparagraph (D) thereof and by ignoring the potential participation in corporate growth that the conversion feature may offer ("convertible pure preferred stock"), (iii) identify certain convertible stock that will be treated as not constituting an "interest that is similar to an option", and (iv) grant the Service the authority to issue revenue rulings providing additional exceptions under section 1.382-2T(h)(4)(x).

Except as provided in regulations, section 382(k)(6)(A) of the Code defines "stock" as stock other than stock described in section 1504(a)(4). Section 1504(a)(4) provides that the term "stock" excludes any stock that is not entitled to vote, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and is not convertible into another class of stock. Thus, any convertible stock generally constitutes "stock" under section 382(k)(6)(A). But see section 1.382-2T(f)(18)(ii).

Convertible stock also may be subject to the option attribution rules of section 1.382-2T(h)(4)(i) of the temporary regulations (the "option rules"). Section 382(l)(3)(A) of the Code generally provides that the option attribution rules of section 318(a)(4) shall apply to an option or similar interest if application of that rule would result in an ownership change. Section 1.382-2T(h)(4)(v)(A) sets forth a nonexclusive list of interests that are similar to an option for purposes of section 382 (*e.g.*, warrants, puts, convertible debt instruments, etc.). Although the term "convertible stock" is not specifically enumerated in that list, such an instrument provides the owner with a right to acquire stock of the loss corporation and, subject to the exception set forth below in the first paragraph under the heading "Other Classes of Convertible Stock", will be subject to the option rules.

Convertible Pure Preferred Stock

The Service has determined that, for purposes of section 382(k) of the Code, convertible pure preferred stock should be treated similarly to convertible debt. Accordingly, the Service will, pursuant to its regulatory authority under section 382(k)(6)(B)(ii), treat convertible stock as not constituting stock if, at the time the instrument is issued, it would be described in section 1504(a)(4) by disregarding subparagraph (D) thereof and by ignoring the potential participation in corporate growth that the conversion feature may offer. Instead, such an instrument will be treated solely as an "interest that is similar to an option." Such an instrument nevertheless shall continue to be treated as "stock" for purposes of section 382(e) (which does not exclude stock described in section 1504(a)(4)).

Other Classes of Convertible Stock

The Service also plans to clarify the treatment of classes of convertible stock other than convertible pure preferred stock (*e.g.*, convertible preferred stock that has voting rights) for the purpose of analyzing whether there is an ownership change on any testing date. Any class of convertible stock not described in the preceding paragraph will be treated solely as stock and will not be treated as an option or an interest similar to an option under section 1.382-2T(h)(4)(v) of the temporary regulations as long as the terms of the conversion feature do not permit or require the tender of any consideration other than the stock being converted. This clarification that the option rules will not be applied to such convertible stock will not prevent the recharacterization of such an ownership interest as constituting "not stock" under section 1.382-2T(f)(18)(ii). For purposes of that analysis, the conversion feature shall be taken into account in determining the likely participation of the instrument in future corporate growth.

The Service is studying the appropriate treatment under section 382 of interests that are both stock and subject to the option rules (*e.g.*, convertible stock, other than convertible pure preferred, that permits or requires the tender of any consideration other than the stock being converted). The

Service invites taxpayers to comment on the rules described in this notice. In particular, comments are invited regarding any additional rules that may be appropriate in applying the option rules to convertible stock.

The amendments to the temporary regulations described in this notice (including the rules described below under the heading "Effective Date") will not affect the rules that may apply under section 1.382-2T(f)(18)(ii) of the temporary regulations to recharacterize "stock" as "not stock".

Effective Date

The amendments to the temporary regulations generally will apply with respect to stock issued on or after July 20, 1988. Unless the election described below is timely filed to make the amendments retroactive, convertible stock (including convertible pure preferred stock) issued prior to July 20, 1988 will be treated as "stock" and not as an "interest that is similar to an option" for purposes of section 382 of the Code. But see section 1.382-2T(f)(18)(ii).

Loss corporations may elect to treat the amendments to be made to the temporary regulations described in this notice as effective on and after May 6, 1986. The election, if made, is effective (i) for all classes of convertible stock of the loss corporation outstanding at any time on or after May 6, 1986, and, (ii) solely for the purpose of determining if there is an ownership change with respect to the loss corporation making the election, for all classes of convertible stock outstanding at any time on or after May 6, 1986, of a corporation owning, directly or indirectly, stock of the loss corporation.

The election must be made by filing a statement of election on or before the later of (i) October 18, 1988, or (ii) the due date (including extensions) of the first information statement required by section 1.382-2T(a)(2)(ii) of the temporary regulations following June 20, 1988. The statement must be filed with the District Director with whom the loss corporation would file its Federal income tax return. The statement may be filed on a plain sheet of paper at the top of which is typed "STATEMENT OF ELECTION FILED UNDER NOTICE 88-67" and must (i) contain the taxpayer's name, address, and employer identification number and (ii) be signed by a person authorized to sign the income tax return of the loss corporation.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

The collection of information in this notice has been submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1980 and has been approved by OMB (Control Number 1545-0123).

Guidance on Application of Section 457 to Vacation Leave, Sick Leave, and Other Benefit Plans

Notice 88-68[1]

Section 457 of the Internal Revenue Code, as amended by the Tax Reform Act of 1986, provides that amounts of compensation deferred under certain "eligible deferred compensation plans" maintained by state and local governments and tax-exempt employers are only included in a participant's or beneficiary's gross income in the taxable year in which the compensation is paid or otherwise made available to that individual. In general, if the plan is not an "eligible deferred compensation plan", the deferred amounts are included in the individual's gross income in the first taxable year of the individual for which there is no substantial risk of forfeiture.

Question and answer 26 in Notice 87-13, published in 1987-1 C.B. 432, clarifies that section 457 applies to both elective and nonelective deferred compensation plans of state and local governments and tax-exempt employers. In Notice 88-8, page 477, this Bulletin, the Service announced that section 457 will not apply to nonelective deferred compensation plans maintained by state and local governments and tax-exempt organizations for taxable years of employees beginning before January 1, 1988. In addition, Notice 88-8 provides that section 457 will not apply to bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, and death benefit plans maintained by state and local governments and tax-exempt organizations for taxable years of employees beginning before the issuance of guidance describing the extent to which these forms of compensation are subject to section 457. Finally, this Notice states that the Service is studying a number of issues under section 457, including the extent to which these plans are subject to section 457, and that further guidance will be provided on these issues.

Based on further study, the Service has determined that regulations under section 457 will provide that bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, and death benefit plans are not deferred compensation plans subject to section 457. This rule will apply without regard to whether such a plan is elective or nonelective in nature.

No inference should be drawn from this notice as to any issue not specifically addressed herein. A number of issues remain with respect to section 457, including when a vacation leave, sick leave, compensatory time, or severance pay plan is bona fide, and not a mere device to provide deferred compensation. The Service continues to study these other issues and welcomes all comments and suggestions. Further guidance will be provided on these issues.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

---

[1] Also released as News Release IR-88-96, dated June 9, 1988.

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 88-1

CONTENTS

SECTION 1. PURPOSE
SECTION 2. SCOPE
SECTION 3. CHANGES
SECTION 4. GENERAL PRACTICE AND DEFINITIONS

.01 Issuance of rulings by National Office
.02 Issuance of determination letters by District Director
.03 Taxpayer
.04 Ruling
.05 Determination letter
.06 Information letter
.07 Revenue ruling
.08 Closing agreement

SECTION 5. RULINGS ISSUED BY THE NATIONAL OFFICE

.01 In income and gift tax matters—when rulings will be issued on consummated transactions, section 1.9100-1 requests, and specific procedures for accounting period and method changes
.02 In estate tax matters
1. In matters involving additional tax under section 2034A(c)
.03 In generation-skipping transfer tax matters
.04 In employment and excise tax matters
.05 In administrative provisions matters
.06 Rulings to business associations or groups
.07 Rulings pending adoption of regulations
  1. Usual procedures
  2. Issue is not clear

SECTION 6. DETERMINATION LETTERS ISSUED BY DISTRICT DIRECTOR

.01 In income and gift tax matters
.02 In estate tax matters
.03 In generation-skipping transfer tax matters
.04 In employment and excise tax matters
.05 Letters not issued by District Director
.06 Letters issued under section 1033 of the Code
.07 Requests concerning income, estate or gift tax return

SECTION 7. DISCRETIONARY AUTHORITY TO ISSUE RULINGS AND DETERMINATION LETTERS

.01 No rule areas
.02 Alternative plans
.03 Ordinarily no ruling on only part of an integrated transaction
.04 Constructive sales price under section 4216(b) or 4218(c) of the Code

SECTION 8. INSTRUCTIONS TO TAXPAYER

.01 Duplicate request for ruling
.02 Penalties of perjury statement
.03 Issuance of single ruling letter
.04 Multiple issue ruling request
.05 Complete statement of facts and other information required. Specific guidelines for requesting rulings under certain Code sections
.06 Statement required as to identical issue in return
.07 "Two-part" ruling requests
1. Complete statement of facts
2. Summary statement of facts to be controlling
(a) Election of "two-part" procedure
(b) Taxpayers rights and responsibilities
(c) Service's rights
(d) Inconsistent with other procedures
.08 Statement of relevant authorities in support of taxpayer's views
.09 Statement of deletions under section 6110 of the Code
.10 Requests to be signed by taxpayer or authorized representative who must be
1. an attorney
2. a certified public accountant
3. a person enrolled to practice before the Service, and have a power of attorney (Form 2848)
4. a foreign representative who has received a "Letter of Authorization" from the Director of Practice, pursuant to section 10.7(b) of Treasury Department Circular No. 230.
.11 Copies of ruling letter
.12 Office where request for ruling and determination letter should be sent
.13 Request for ruling that lacks essential information
.14 Request for conference
.15 Requests for ruling processed in regular order, expeditious handling procedures
.16 Individual Tax Division primary responsibility
.17 Corporation Tax Division primary responsibility
.18 Employee Benefits and Exempt Organizations Division primary responsibility
.19 Status request
.20 Section 6110 procedures regarding protest of disclosure of ruling letter
.21 Request for delay of public inspection
.22 Attach a copy of ruling letter to taxpayer's return
.23 Appeal procedures for adverse determination letters under section 521 of the Code.
.24 Director of Practice will be informed of what are believed to be violations of Treasury Department Circular No. 230.

SECTION 9. HANDLING OF RULING REQUESTS

.01 21-calendar day contact
.02 Subject matters included in a 21-day procedure
1. Individual Tax Division
2. Corporation Tax Division
3. Employee Benefits and Exempt Organizations Division
.03 Procedures followed regarding ruling requests
1. 21-calendar day Branch contact
2. Multiple Branch jurisdiction
3. Modification transaction
4. Informal opinions not binding
5. Process under present procedures

SECTION 10. CONFERENCES IN THE NATIONAL OFFICE

.01 Conference only in connection with a ruling request: how it is scheduled
.02 One conference of right; who will attend from the Service
.03 Employment tax matters
.04 No tape or other verbatim recording

.05 Tentative recommendations
.06 Additional conferences
.07 Post conference submissions

SECTION 11. DISTRICT OFFICE REFERRAL OF MATTERS TO THE NATIONAL OFFICE
.01 Request for determination letters
.02 No rule areas

SECTION 12. REFERRAL OF MATTERS TO DISTRICT OFFICES

SECTION 13. REVIEW OF DETERMINATION LETTERS

SECTION 14. WITHDRAWAL OF REQUESTS

SECTION 15. ORAL ADVICE TO TAXPAYERS
.01 Discuss substantive and procedural tax issues
.02 Technical assistance from District Office or Service Center

SECTION 16. EFFECT OF RULINGS
.01 Reliance, revocation or modification: section 7805(b)
.02 District Director's responsibility
.03 Contrary conclusion by field office
.04 Ways in which a ruling found to be in error is modified or revoked
.05 Situation in which revocation or modification of a ruling will not be applied retroactively except in rare or unusual circumstances
.06 Application of ruling restricted to transaction; not affected by regulations issued later
.07 Retroactivity; ruling on continuing or series of actions, illustrations
.08 Retroactivity; sale or lease subject to excise tax
.09 Retroactivity; completed transaction

SECTION 17. EFFECT OF DETERMINATION LETTERS

SECTION 18. EFFECT OF INFORMATION LETTERS

SECTION 19. PROCEDURE FOR REQUESTING APPLICATION OF SECTION 7805(b) IN THE CASE OF RULINGS AND DETERMINATION LETTERS
.01 Application of section 7805(b) of the Code
.02 Form of request to limit the retroactive effect of a modification or revocation of a ruling letter
.03 Taxpayer's right to conference
.04 Form of request to limit the retroactive effect of a modification or revocation of a determination letter
.05 Taxpayer's right to a conference when technical advice is requested

SECTION 20. EFFECT ON OTHER DOCUMENTS

SECTION 1. PURPOSE

The purpose of this revenue procedure is to update Rev. Proc. 87-1, 1987-1 C.B. 503, which provides procedures for issuing rulings, determination letters and information letters, and for entering into closing agreements on specific issues involving the interpretation or application of the federal tax laws. It also tell taxpayers and their representatives where to send requests for rulings, determination letters and information letters. It gives the steps to follow so that requests may be handled more efficiently. Changes to this revenue procedure will be incorporated annually in a new revenue procedure published as the first revenue procedure of the year.

SEC. 2. SCOPE

.01 The Chief Counsel through the Associate Chief Counsel (Technical and International) provides basic principles and rules for the uniform interpretation and application of the federal tax laws under the jurisdiction of the Associate Chief Counsel (Technical and International).

.02 This revenue procedure applies only to ruling requests, information letters, and closing agreements under the jurisdiction of the Associate Chief Counsel (Technical and International) that do not relate to international transactions, and to requests for determination letters under the jurisdiction of field offices that relate to Code sections under the jurisdiction of the Associate Chief Counsel (Technical and International) that do not relate to international transactions. The procedures for obtaining rulings, closing agreements, and information letters on specific tax issues involving the interpretation or application of the federal tax laws and income tax treaties relating to international transactions are contained in Rev. Proc. 87-4, 1987-1 C.B. 529.

.03 The procedures for obtaining rulings, etc., that apply specifically to federal firearms, alcohol and tobacco taxes under subtitle E of the Internal Revenue Code are under the jurisdiction of the Bureau of Alcohol, Tobacco and Firearms. The procedures for obtaining rulings, determination letters, etc., on employee plans and exempt organizations are under the jurisdiction of the Assistant Commissioner (Employee Plans and Exempt Organizations). See Rev. Proc. 83-36, 1983-1 C.B. 763, as modified by Rev. Proc. 87-40 1987-2 C.B. 514. However, the jurisdiction of the Associate Chief Counsel (Technical and International) include section 521 of the Code, on exemption of farmer's cooperatives from tax; section 526, on shipowners' protection and indemnity associations; section 527(a), (b), (c), (d), (e), and (g), on political organizations, and section 528 on certain homeowners associations.

SEC. 3. CHANGES

.01 References throughout the revenue procedure to the Associate Chief Counsel (Technical) are changed to the Associate Chief Counsel (Technical and International) to reflect the combination of the Technical and International organizations under one Associate Chief Counsel.

.02 Section 4.04 is amended to refer to the Employee Benefits and Exempt Organizations Division in addition to the Corporation Tax Division and the Individual Tax Division.

.03 Section 5.02 is amended to provide that the National Office will consider prospective estate tax rulings on issues involving sections 2041 and 2056 of the Code during a proposed 1-year test period. See Rev. Proc. 87-58, 1987-2 C.B. 764.

.04 Section 5.07 is amended to

reflect the modifications made to that section by Rev. Proc. 87-7, 1987-1 C.B. 542.

.05 Section 8.05 is amended to provide that an extension of the 21-day period for post-conference submissions must be approved by the Associate Director or Deputy Associate Director having jurisdiction over the Branch to which the case is assigned.

.06 Section 8.05 is amended by the addition of Rev. Proc. 87-28, 1987-1 C.B. 770 (guidelines for a request for a ruling under section 162(k)) to the list of revenue procedures providing specific guidelines for requesting rulings under certain Code sections.

.07 Section 8.05 is amended by the addition of Rev. Proc. 87-32, 1987-2 C.B. 396 (guidelines for requesting to adopt, retain or change an accounting period for partnerships, S corporations, and personal service corporations) to the list of revenue procedures providing specific guidelines for requesting rulings under certain Code sections. Rev. Proc. 87-32 modifies and supersedes Rev. Proc 83-25, 1983-1 C.B. 689 as modified.

.08 Section 8.12 is amended to provide a new mailing address for requests for rulings and a new room number for hand delivered requests.

.09 Section 8.18 is amended by redesignating such section 8.19 and by inserting a new section 8.18 before such section that describes the primary responsibility of the Director, Employee Benefits and Exempt Organizations Division.

SEC. 4. GENERAL PRACTICE AND DEFINITIONS

.01 The Service answers inquiries of individuals and organizations, when appropriate in the interest of sound tax administration, about their status for tax purposes and the tax effects of their acts or transactions. The National Office issues rulings in such matters.

.02 District Directors of the Internal Revenue Service apply the statutes and tax treaties, regulations, revenue rulings, and other precedents published in the Internal Revenue Bulletin in determining tax liability, collecting taxes, and issuing information letters and determination letters in answer to taxpayers' inquiries or requests. For purposes of this revenue procedure, any reference to District Director or District Office includes their respective offices or, when appropriate, the Director of an Internal Revenue Service Center.

.03 The word "taxpayer" includes all persons subject to any provision of the Internal Revenue Code and, when appropriate, their representatives and issuers of section 103 obligations. Any reference to National Office means only the Office of the Associate Chief Counsel (Technical and International).

.04 A "ruling" is a written statement issued to a taxpayer by the National Office that interprets and applies the tax laws to that taxpayer's specific set of facts. Rulings are issued only by the National Office, under the general supervision of the Associate Chief Counsel (Technical and International). Issuing rulings has been largely delegated to the Directors of the Corporation Tax Division, the Individual Tax Division and the Employee Benefits and Exempt Organizations Division.

.05 A "determination letter" is a written statement issued by a District Director in response to a written inquiry by a taxpayer that applies the principles and precedents previously announced by the National Office to a specific set of facts. A determination letter is issued only when a determination can be made on the basis of clearly established rules in the statute or regulations, or by a position in a ruling, opinion, or court decision published in the Internal Revenue Bulletin that specifically answers the question presented. A determination letter will not be issued if a determination cannot be made, for example, when the question presents a novel issue, or if the matter is excluded from the jurisdiction of a District Director under section 6 of this revenue procedure.

.06 An "information letter" is a statement issued either by the National Office or by a District Director that calls attention to a well-established interpretation or principle of tax law, without applying it to a specific set of facts. It may be issued if the request indicates that the taxpayer is seeking general information. If the request does not meet the requirement of section 8 of this revenue procedure, but the Service thinks that the general information may help the individual or organization, it may issue an information letter.

.07 A "revenue ruling" is an interpretation by the Service that has been published in the Internal Revenue Bulletin. It is the conclusion of the Service on how the law is applied to an entire set of facts. Revenue rulings are issued only by the National Office and are published for the information and guidance of taxpayers. Internal Revenue Service officials, and other interested parties.

Since each revenue ruling represents the conclusion of the Service as to the application of the law to the entire statement of facts involved, taxpayers, Service personnel, and others concerned are cautioned against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same. They should consider the effect of subsequent legislation, regulations, court decisions, and revenue rulings. See Rev. Proc. 86-15, 1986-1 C.B. 544.

.08 A "closing agreement" is an agreement between the Commissioner of Internal Revenue or the Commissioner's delegate and a taxpayer on a specific issue or issues or liability that is entered into under the authority in section 7121 of the Code. A closing agreement prepared in an office under the responsibility of the Associate Chief Counsel (Technical and International) is based on a ruling that has been signed by the Commissioner, or the Commissioner's delegate, that says that a closing agreement will be entered into on the basis of the holding of the ruling letter. Closing agreements are final, unless fraud, malfeasance, or misrepresentation of a material fact can be shown. Closing agreements may be entered into when it is advantageous to have the matter permanently and conclusively closed, or when a taxpayer can show good and sufficient reasons for an agreement and the government will sustain no disadvantage by its consummation. In appropriate cases, taxpayers may be asked to enter into a closing agreement as a condition to the issuing of a ruling. If, in a single case, closing agreements are requested for each of a number of taxpayers, such agreements are entered into only if the number of taxpayers is 25 or less.

However, if the issue and holding are identical for all taxpayers and they number more than 25, a "mass closing agreement" will be entered into with the taxpayer who is authorized by the others to represent the entire group.

SEC. 5. RULINGS ISSUED BY THE NATIONAL OFFICE

.01 *In income and gift tax matters*, the National Office issues rulings on prospective transactions and on completed transactions that occurred before the return is filed for the year in which such transactions are consummated. However, see Rev. Proc. 79-63, 1979-2 C.B. 578, which concerns applications for extensions of the time for making an election or application for relief under section 1.9100-1 of the regulations. If a request for an extension of time under section 1.9100-1 is submitted after the return is filed but before the return is examined, the procedures under Rev. Proc. 88-1 are applicable. If an examination of the return has begun, or is being considered by an Appeals Office, the procedures of Rev. Proc. 88-2, page 571, this Bulletin, are applicable. The National Office issues rulings on the exempt status of organizations under section 521. See Rev. Proc. 84-46, 1984-1 C.B. 541. Specific instructions and guidelines relating to corporate distributions and the determination of the earnings and profits of corporate taxpayers are contained in Rev. Proc. 75-17, 1975-1 C.B. 677. In such matters only the provisions of sections 8.02, 8.10, 8.11, 8.14, 8.17, and 10 of this revenue procedure (Rev. Proc. 88-1) are applicable. Specific instructions and guidelines relating to a change in method of accounting for federal income tax purposes are contained in Rev. Proc. 84-74, 1984-2 C.B. 736. In such matters only the provisions of sections 7.02, 8.02, 8.05, 8.08, 8.10, 8.11, 8.15, 8.17, 8.18 and 8.21, 10, 14, 15 and 16 of this revenue procedure (Rev. Proc. 88-1) are applicable. In matters relating to accounting period changes only the provisions of sections 7.02, 8.02, 8.05, 8.08, 8.10, 8.11, 8.15, 8.17, 8.18, and 8.21, 10, 14, 15, and 16 of this revenue procedure (Rev. Proc. 88-1) are applicable. The National Office ordinarily does not issue rulings if, at the time the ruling is requested, the identical issue is involved in the taxpayer's return for an earlier period, and (1) that issue is being examined by a District Director or is being considered by an Appeals Office, or (2) that issue has been examined by a District Director or considered by an Appeals Office and the statutory period of limitation on either assessment or for filing a claim for refund or credit of tax has not expired, or a closing agreement covering the issue or liability has not been entered into by a District Director or by an Appeals Office. If a return dealing with an issue for a particular year is filed while a request for ruling on that issue is pending, the National Office will issue the ruling unless it is notified by the taxpayer that an examination of that issue or the identical issue on an earlier year's return has been started by a District Director. See Section 8.06. However, even if an examination has begun, the National Office ordinarily will issue the ruling if the District Director agrees, by memorandum, to permit the ruling to be issued. The National Office does not issue rulings on the replacement of involuntarily converted property, whether or not replacement has been made, if the taxpayer has already filed a return for the tax year in which the property was converted. See section 6.06 for the District Director's authority to issue determination letters in this connection. In addition, the National Office generally does not issue rulings on the classification of an organization if a return has been filed for the organization for an earlier period. However, the National Office will consider ruling requests concerning the classification of an existing organization as a partnership. See Rev. Proc. 86-12, 1986-1 C.B. 534.

.02 *In estate tax matters*, the National Office issues rulings with respect to transactions affecting the estate tax of a decedent before the estate tax return is filed. If the estate tax return is due to be filed before the ruling is issued, the taxpayer should secure an extension of time for filing the return for the maximum period of six months, and notify the National Office Branch considering the request for ruling that an extension has been secured. If the return is filed before the ruling is issued, the taxpayer must disclose on the return that a ruling has been requested, attach a copy of the pending ruling request to the return, and notify the National Office that the return has been filed. The National Office will make every effort to issue the ruling within three months of the day on which the return was filed. If the ruling cannot be issued within that three month period, the National Office will notify the District Director having jurisdiction of the return who may, by memorandum to the National Office, grant an additional period for the issuance of the ruling. The National Office generally will not rule on matters relating to the application of the estate tax to property or the estate of a living person. However, the National Office will consider prospective estate tax rulings on issues involving sections 2041 and 2056 of the Code. See Rev. Proc. 87-58, 1987-2 C.B. 764.

1. *In matters involving additional tax under section 2032A(c)*, the National Office issues rulings on prospective transactions and on completed transactions that occurred before the return is filed for the year in which such transactions are consummated.

.03 *In generation-skipping transfer tax matters*, the National Office issues rulings on transactions that affect the generation-skipping transfer tax before the return is filed. In the case of a generation-skipping trust, or trust equivalent, rulings are not issued until after the trust or trust equivalent, has been established. Rulings may be issued on a generation-skipping transfer tax matter before a "direct skip" transfer takes place. Notwithstanding the foregoing, the National Office will issue rulings regarding the application of the generation-skipping transfer tax effective date rules (section 1433 of the Tax Reform Act of 1986, Pub. L. No. 99-514) to wills, trusts and trust equivalents in existence on October 22, 1986, and to generation-skipping transfers taking place on or before October 22, 1986.

.04 *In employment and excise tax matters*, the National Office issues rulings on prospective transactions and on completed transactions either before or after the return is filed for those transactions. In employment tax matters, generally the taxpayer is the employer. However, if the worker asks for the ruling, both the worker and the employer are considered to be the taxpayer and both are entitled to the ruling. The National Office usually will not issue rulings if, at the time the ruling is requested, the identical issue is involved in the taxpayer's return for an earlier period and (1) that issue is under examination by a District Director or under consideration by an Appeals Office, or (2) that issue has been examined by a District Director or considered by an Appeals Office and the statutory period of limitation on either assessment or for filing a claim for refund or credit of tax has not expired, or a closing agreement covering the issue or liability has not been entered into by a District Director or by an Appeals Office. However, if a District Director began an examination of the issue involved in the ruling request, the National Office usually will issue the ruling if the District Director agrees, by memorandum, to permit the ruling to be issued.

.05 *In administrative provisions matters*, the National Office issues rulings on issues arising under the Internal Revenue Code, and related statutes, and the regulations thereunder, that relate primarily to the time, place, manner, and procedures, for reporting and paying taxes; assessing and collecting taxes (including interest and penalties); abating, crediting, or refunding overassessments or overpayments of tax; and filing information returns. Rulings ordinarily are not issued, if, at the time the ruling is requested, the identical issue is involved in the taxpayer's return for an earlier period and (1) that issue is being considered by a District Director or an Appeals Office, or (2) that issue has been examined by a District Director or considered by an Appeals Office and the statutory period of limitation on either assessment or for filing a claim for refund, or credit of tax has not expired, or a closing agreement covering the issue or liability has not been entered into by a District Director or Appeals Office. If a return involving an issue for a particular year is filed while a request for a ruling on that issue is pending, the National Office will issue the ruling unless an examination of that issue or an examination of the identical issue on an earlier year's return has been started by a District Director. But, even if consideration has begun, the National Office ordinarily will issue the ruling if the District Director agrees, by memorandum, to permit the ruling to be issued.

.06 The National Office does not issue rulings to business, trade, or industrial associations or to similar groups concerning the application of the tax laws to members of the group. It may, however, issue rulings to these groups or associations on their own tax status or liability if the request meets the requirements of this section. Furthermore, such groups or associations may submit suggestions of generic issues that would be appropriately addressed in revenue rulings.

.07 Pending the adoption of regulations (either temporary or final) that interpret the provisions of any act, the issuing of rulings will be considered under the following conditions.

1. If the ruling request presents an issue on which the answer seems clear by applying the statute to the facts, a ruling will be issued under the usual procedures.

2. If the ruling request presents an issue on which the answer seems reasonably certain but not entirely free from doubt, a ruling will be issued. However, section 2.01 of Rev. Proc. 87-7, 1987-1 C.B. 542 modifies this rule by excepting from its conditions a list of Code sections enacted or amended by the Tax Reform Act of 1986. Section 2.02 of Rev. Proc. 87-7 provides that for Code sections listed in section 2.01 of that revenue procedure, the appropriate Branch in the office of the Associate Chief Counsel (Technical and International) will entertain all ruling requests and do its best to issue a ruling even if the answer does not seem reasonably certain.

However, if the ruling request presents an issue that cannot be readily resolved before regulations are issued, a ruling will not be issued. However, section 2.03 of Rev. Proc. 87-7 provides that where the Service has closed a regulations project or does not intend to open a regulations project, the appropriate Branch will entertain all ruling requests unless the issue is covered by section 7 of Rev. Proc. 88-1 or by Rev. Proc. 88-3, page 579, this Bulletin.

SEC. 6. DETERMINATION LETTERS ISSUED BY DISTRICT DIRECTOR

.01 *In income and gift tax matters*. District Directors issue determination letters in response to taxpayers' written requests on completed transactions that affect returns over which they have examination jurisdiction. This applies only if the question presented is specifically answered by statute or regulation, or by a position stated in a ruling, opinion or court decision published in the Internal Revenue Bulletin. A determination letter usually is not issued for a question concerning a return to be filed by the taxpayer if the same question is involved in a return already filed. District Directors do not issue determination letters on the tax consequences of prospective or proposed transactions, except as provided in section 6.06.

.02 *In estate tax matters*. District Directors issue determination letters in response to written requests affecting the estate tax returns over which they have examination jurisdiction, but only if the question presented is specifically answered by statute or regulation, or by a position stated in a ruling, opinion, or court decision published in the Internal Revenue Bulletin. District Directors do not issue determination letters on matters concerning the application of the estate tax to property or the estate of a living person.

.03 *In generation-skipping transfer tax matters*, District Directors issue determination letters in response to written requests affecting the generation-skipping transfer tax returns over which they have examination jurisdiction, but only if the questions presented are speficially answered by statute or regulation, or by a position stated in a ruling, opinion, or court decision published in the Internal Revenue Bulletin. District Directors do not issue determination letters on matters concerning the application of the generation-skipping transfer tax before the distribution or termination takes place.

.04 *In employment and excise tax matters*, District Directors issue determination letters on completed transactions in response to written requests from taxpayers over which they have examination jurisdiction, but only if the question presented specifically answered by statute or regulation, or by a position stated in a ruling, opinion, or court decision published in the Internal Revenue Bulletin.

.05 Notwithstanding the provisions of section 6.01, 6.02, 6.03, and 6.04, a District Director will not issue a determination letter in response to a request that presents a question specifically answered by statute or regulation, or by a position stated in rulings, etc., published in the Internal Revenue Bulletin, if (1) if appears that the taxpayer has directed a similar inquiry to the National Office, (2) the same issue involving the same taxpayer is pending in a case before an Appeals Office, (3) the determination letter is requested by an industry, trade association, or similar group, or (4) the request involves, an industry-wide problem. Under no circumstances will a District Director issue a determination letter unless it is clearly shown that the request concerns a return that has been filed or is required to be filed over which the District Director has or will have examination jurisdiction. Notwithstanding the provisions of section 6.04, a District Director will not issue a determination letter on an employment tax question if the specific question for the same taxpayer has been or is being considered by the Central office of the Social Security Administration or the Railroad Retirement Board. Nor will District Directors issue determination letters for determination of a constructive sales price under section 4216(b) or 4218(c) of the Code. The National Office, however, will issue rulings in this area. See section 7.04.

.06 District Directors issue determination letters on the replacement of involuntarily converted property under section 1033 even though the replacement has not been made, if the taxpayer has filed an income tax return for the year in which the property was involuntarily converted.

.07 A request received by a District Director on a question concerning an income, estate, or gift tax return already filed will be, in general, considered in connection with the examination of the return. If a response is made to such a request before the return is examined, it will be considered a tentative finding in any later examination of that return.

SEC. 7. DISCRETIONARY AUTHORITY TO ISSUE RULINGS AND DETERMINATION LETTERS

.01 The Service ordinarily will not issue rulings or determination letters in certain areas because of the factual nature of the problem involved, or for other reasons. Rev. Proc. 88-3, page , this Bulletin, provides a list of these areas. This list is not all inclusive, since the Service may decline to issue a ruling or a determination letter on other grounds, whenever warranted by the facts or circumstances of a particular case. The National Office and District Directors may, when it is considered appropriate and in the best interest of the Service, issue information letters calling attention to well-established principles of tax law.

.02 A ruling or a determination letter is not issued on alternative plans of proposed transactions or on hypothetical situations.

.03 The National Office ordinarily will not issue rulings on only part of an integrated transaction.

.04 The National Office will issue rulings in all cases on the determination of a constructive sales price under section 4216(b) or 4218(c) and in all other cases on prospective or future transactions if the law or regulations require a determination of the effect of a proposed transaction for tax purposes.

SEC. 8. INSTRUCTIONS TO TAXPAYER

.01 The taxpayer should submit a request for a ruling or a determination letter in duplicate if (1) more than one issue is presented in the request, or (2) a closing agreement is requested on the issue presented. It is not necessary to submit requests in duplicate under other circumstances except as set forth in section 8.09.

.02 A request for a ruling or determination letter and any factual information or change in the ruling request submitted at a later time must be accompanied by a declaration in the following form: "Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and to the best of my knowledge and belief, the facts presented in support of the requested ruling or determination letter are true, correct, and complete." The declaration may not be made by the taxpayer's representative. It must be signed by the person or persons on whose behalf the request is made. The person who must sign for a corporate taxpayer must be an officer of the corporate taxpayer who has personal knowledge of the facts. The officer must be one whose duties are not limited to obtaining a ruling or determination letter from the Service. Furthermore, if the corporate taxpayer is a member of an affiliated group filing consolidated returns, a penalties of perjury statement must also be submitted by the common parent of the group. The person signing for a trust or partnership must be a trustee or partner who has personal knowledge of the facts.

.03 If more than one issue is presented in a request for a ruling, the Service generally will issue a single ruling letter. However, the taxpayer may request a separate ruling letter on any of the issues. Unless the Service determines that it is not feasible or not in the best interest of the Service to comply with such a request, it will issue separate ruling letters.

.04 When multiple issues are involved in a single factual situation and separate letters requesting rulings are submitted, a statement to this effect must be included in each ruling letter request. The Service in issuing each ruling will state that separate rulings have been issued or requests for rulings are pending.

.05 Each request for a ruling or a determination letter must contain a complete statement of all of the facts relating to the transaction. Such facts include: names, addresses, telephone numbers, and taxpayer identification numbers of all interested parties; the location of the District Office that has or will have examination jurisdiction over the return, not the Service Center where the return is filed; a full and precise statement of the business reasons for the transaction, and a carefully detailed description of the transaction. (The term "all interested parties" does not mean that a list is required of all shareholders of a widely-held corporation requesting a ruling relating to a reorganization, or a list of employees where a larger number may be involved.) If the request deals with only one step of a larger integrated transaction, the facts, circumstances, etc. relating to the entire transaction must be submitted. However, see section 7.03 of this revenue procedure (Rev. Proc. 88-1). In addition, true copies of all contracts, wills, deeds, agreements, instruments, and other documents in the transaction must be submitted with the request. Original documents, such as contracts, wills, etc., should not be submitted because they become part of the Service's file and will not be returned. All material facts in documents must be included in the taxpayer's letter requesting a ruling or in supplemental letters, and not merely incorporated by reference, and must be accompanied by an analysis of their bearing on the issue or issues, specifying the provisions that apply. If the request concerns a corporate distribution, reorganization, or similar transaction, the corporate balance sheet and profit and loss statement should be submitted. If the request relates to a prospective transaction, the most recent balance sheet and profit and loss statement should be submitted.

Material facts furnished to the Service by telephone or orally at a conference must be promptly confirmed by letter to the Service with a declaration in the form described in section 8.02. This confirmation must be furnished within 21 calendar days to be considered part of the request. An extension of the 21-day period will be granted only if justified in writing by the taxpayer and approved by the Associate Director or Deputy Associate Director having jurisdiction over the Branch to which the case is assigned. A request for extension should be submitted before the end of the 21-day period. If unusual circumstances close to the end of the 21-day period make a written request impractical, within the 21-day period the National office should be told of the problem and that the written request for extension will be coming soon. Such a request must be sent promptly. The taxpayer or taxpayer's representative will be told promptly and later in writing of the approval or denial of the requested extension. There is no right of appeal to a denial of an extension request. Because the purpose of these procedures is to speed up the ruling process, the taxpayer is encouraged to submit the required relevant material promptly. Therefore, requests for extension should be justified by compelling facts and circumstances. If the Service is not made aware, as provided above, of problems in meeting the 21-day period, or if the request is not sent promptly after the National Office is notified of problems in meeting the 21-day period, the Service will process the case on the assumption that no further submission will be received.

Specific guidelines for requesting rulings under certain Code sections follows: Rev. Proc. 84-48, 1984-1 C.B. 547, as amplified by Rev. Proc. 84-49, 1984-1 C.B. 548, and Rev. Proc. 84-50, 1984-1 C.B. 550, (guidelines for submitting request for rulings under sections 103 and 7478); Rev. Proc. 68-11, 1968-1 C.B. 761 (guidelines for a ruling request under section 117); Rev. Proc. 87-28, [1987-1 C.B. 770] (guidelines for a request for a ruling under section 162(k)); Rev. Proc. 86-18, 1986-1 C.B. 551 (guidelines concerning a request for a ruling under section 302 or 311); Rev. Proc. 81-68, 1981-2 C.B. 723 (guidelines concerning a request for a ruling under section 332, 334(b)(1) or 334(b)(2)); Rev. Proc. 86-16, 1986-1 C.B. 546 (guidelines concerning a request for a ruling under sections 331 and 337); Rev. Proc. 81-42, 1981-2 C.B. 611 (guidelines concerning a request for a ruling under section 302(b)(4)); Rev. Proc. 83-59, 1983-2 C.B. 575 (guidelines concerning a request for a ruling under section 351); Rev. Proc. 86-41, 1986-2 C.B. 716 (guidelines concerning a request for a ruling under section 355); Rev. Proc. 81-70, 1981-2 C.B. 729 (guidelines for estimating the basis of stock acquired in a section 368(a)(1)(B) reorganization); Rev. Proc. 81-60, 1981-2 C.B. 680 (guidelines concerning a request for a ruling under sectin 368(a)(1)(E)). See, however, Rev. Proc. 88-3, page 579, this Bulletin, which provides that a ruling whether a transaction constitutes a corporate recapitalization within the meaning of section 368(a)(1)(E) will not be issued except when the recapitalization is an integral part of a larger transaction and it is impossible to determine the tax consequences of the larger transaction without making a determination with regard to the recapitalization. Rev. Proc. 87-22, 1987-1 C.B. 718, and Rev. Proc. 77-37, 1977-2 C.B. 568, as superseded in part by Rev. Proc. 79-14, 1979-1 C.B. 469, and as amplified by Rev. Proc. 83-81, 1983-2 C.B. 598, Rev. Proc. 84-42, 1984-1 C.B. 521 and Rev. Proc. 86-42 1986-2 C.B. 722 (certain other guidelines concerning requests for rulings handled by the Corporation Tax Division); Rev. Proc. 71-19, 1971-1 C.B. 698 (guidelines concerning requests for rulings on unfunded deferred compensation); Rev. Proc. 87-32, 1987-2 C.B. 396 (guidelines for requesting to adopt, retain or change an accounting period for partnerships, S corporations, and personal service corporations); Rev. Proc. 72-13, 1972-1 C.B. 735, Rev. Proc. 74-17, 1974-1 C.B. 438, and Rev. Proc. 75-16, 1975-1 C.B. 676 (guidelines on classification of limited partnerships); Rev. Proc. 82-58, 1982-2 C.B. 847 (guidelines on classification of organizations as liquidating trusts); Rev. Proc. 82-36, 1982-1 C.B. 490 (guidelines concerning requests for consent to elect not to defer gain or loss on deferred intercompany transactions); Rev. Proc. 79-63, 1979-2 C.B. 578 (factors considered and information needed for granting expensions under section 1.9100-1 of the Income Tax Regulations.

A ruling request that involves a question of whether a rate order, proposed or issued by a regulatory agency, will meet the normalization requirements of sections 46(f), 167(1), and 168(f)(2)(pre-Tax Reform Act of 1986, section 163(e)(3)) of the Code, ordinarily will not be considered unless the taxpayer states in the request for ruling whether:

(1) the regulatory authority responsible for establishing or approving the taxpayer's rates has reviewed the request and believes that the request is adequate and complete, and

(2) the taxpayer will permit the regulatory authority to participate in any National Office conference concerning the request.

.06 The request must contain a statement of whether, to the best of the knowledge of the taxpayer and the taxpayer's representative(s), if any, the identical issue is in a prior return of the taxpayer (or in a return for any year of a related taxpayer within the meaning of section 267 of the Code, or of a member of an affiliated group of which the taxpayer is also a member within the meaning of section 1504). If so, the statement must specify whether the issue (1) is being examined by a District Director, (2) has been examined and the statutory period of limitation on either assessment or for filing a claim for refund or credit of tax has not expired, or a closing agreement covering the issue or liability has not been entered into by a District Director, (3) is being considered by an Appeals Office in connection with the taxpayer's return for an earlier period, or has been considered by an Appeals Office and the statutory period of limitation on either assessment or for filing a claim for refund or credit of tax has not expired, or a closing agreement covering the issue or liability has not been entered into by an Appeals Office, or (4) is pending in litigation in a case involving the taxpayer or a related taxpayer. The request must also contain a statement whether, to the best of the knowledge of the taxpayer and the taxpayer's representative(s), if any, (i) the identical or similar issue has been submitted to the Service, by the taxpayer or its predecessor, but withdrawn before a ruling was issued, or (ii) ruled on by the Service to the taxpayer or to the taxpayer's predecessor. If so, the statement must specify the date of submission, withdrawal, or ruling and other details of the Service's consideration of the issue. If, after the request is filed but before a ruling is issued, the taxpayer knows that an examination of the issue by a District Director has been started, the taxpayer must notify the National Office of such action. If a return is filed before a ruling is received from the National Office concerning the issue, a copy of the request must be attached to the return. This alerts the District Office and avoids premature District action on the issue.

.07 As an alternative procedure (known as the "two-part" ruling request procedure) for the issuance of rulings on prospective transactions, the taxpayer may submit a summary of the facts considered to be controlling the issue, in addition to the complete statement required for ruling requests by section 8.05. If the National Office agrees with the summary, the National office will use it as the basis for the ruling. To use this procedure, the taxpayer should submit the following with the request for a ruling:

1. A complete statement of facts about the transaction, together with related documents, as required by section 8.05, and

2. A summary statement of the facts believed to be controlling in reaching the requested conclusion. When the taxpayer's statement of controlling facts is accepted, the Service will base its ruling on these facts and only this statement will ordinarily be incorporated in the ruling letter. It is emphasized, however, that:

(a) The taxpayer may elect this procedure for a "two-part" ruling request. It is not to be considered a required substitute for the regular procedures provided by this revenue procedure.

(b) The taxpayer's rights and responsibilities are the same under the "two-part" ruling request procedure as those provided in this revenue procedure.

(c) The Service reserves the right to rule on the basis of a more complete statement of facts it considers controlling and to seek more information in developing facts and restating them; and

(d) The "two-part" ruling request procedure will not apply, if it is inconsistent with other procedures, such as those dealing with request for permission to change accounting methods or periods; applications for recognition of exempt status undersection 521 of the Code; or rulings on employment tax status.

.08 If the taxpayer advocates a particular conclusion, an explanation of the grounds for the assertion must be furnished, together with a statement of relevant authorities in support of the taxpayer's views. Even though the taxpayer is urging no particular tax treatment of a proposed or prospective transaction, the taxpayer's views on the tax results of the proposed action and a statement of relevant authorities to support those views must be furnished. In addition, the taxpayer is encouraged to inform the Service, and discuss the implications of any legislation, tax treaties, court decisions, regulations, revenue rulings or revenue procedures that the taxpayer determines to be contrary to the position advanced. If the taxpayer determines that there are no contrary authorities, a statement to this effect would be helpful in the ruling request. Identification and discussion of contrary authorities will generally enable Service personnel to arrive more quickly at a full understanding of the issue and the relevant authorities. There is a further advantage to the taxpayer. When Service personnel receive the request, they will have before them the taxpayer's thinking on the effect and applicability of contrary authorities. Such information should, therefore, make research easier and lead to earlier action by the Service. Conversely, failure to disclose and distinguish significant contrary authorities may result in requests for additional memoranda that will delay action on the ruling request.

.09 To assist the Service in making the deletions required by section 6110(c) of the Code from the text of rulings and determination letters, to be made open to public inspection under section 6110(a), a deletions statement must accompany each request. The statement must either state that no information other than names, addresses, and identifying numbers need be deleted or, if more information is proposed to be deleted, the statement must indicate the deletions proposed by the person requesting the ruling or determination letter. If the latter alternative is chosen, the statement must be made in a separate document, and it must be accompanied by a copy of the request for a ruling or determination letter and supporting documents, on which must be shown, by the use of brackets, the material that the person making the request believes should be deleted pursuant to section 6110(c). The statement of proposed deletions must indicate that statutory basis, under section 6110(c), for each proposed deletion. The statement of proposed deletions must not appear or be referred to anywhere in the request for a ruling or determination letter. If the person making the request decides to ask for additional deletions before the ruling or determination letter is issued, additional statements may be submitted. The procedures in this paragraph also apply to additional information that is submitted after the initial request.

.10 A request by or for a taxpayer must be signed by the taxpayer or the taxpayer's authorized representative. If the request is signed by a representative, or if the representative is to appear before the Service in connection with the request, the representative must be:

1. an attorney who is a member in good standing of the bar of the highest court of any state, possession, territory, commonwealth, or the District of Columbia, and who files with the Service a written declaration that he or she is currently qualified as an attorney and is authorized to represent the taxpayer;

2. a certified public accountant who is qualified to practice in any state, possession, territory, commonwealth, or the District of Columbia, and who files with the Service a written declaration that he or she is currently qualified as a certified public accountant and is authorized to represent the taxpayer;

3. a person, other than an attorney or certified public accountant who is currently enrolled to practice before the Service, and who files with the Service a written delcaration that he or she is currently enrolled (including in the declaration either the enrollment number or the expiration date of the enrollment card) and is authorized to represent the taxpayer. (See Treasury Department Circular No. 230 (31 CFR Part 10), 1985-2 C.B. 742, for the rules on who may practice before the Service; or

4. a foreign representative who has received a "Letter of Authorization" from the Director of Practice, pursuant to section 10.7(b) of Treasury Department Circular No. 230. Practitioners may make written request for a "Letter of Authorization" to: Office of Director of Practice, PM:HR:DP, Internal Revenue Service, 1111 Constitution Ave., N.W., Washington, D.C. 20224. Section 10.7(b) of Circular No. 230 authorizes the Commissioner to allow any person to represent another without enrollment for the purpose of a particular matter. Without a "Letter of Authorization," the foreign representative may not represent the taxpayer before the Service.

The requirements above do not apply to an individual representing his or her fulltime employer, or to a bona fide officer, administrator, administratrix, trustee, etc., representing a corporation, trust, estate, association, or organized group. An unenrolled preparer of a return (other than an attorney or certified public accountant referred to in (1) and (2) above) who is not a full-time employee or a bona fide officer, administrator, administratrix, trustee, etc., may not represent a taxpayer in connection with a ruling or a determination letter.

Any authorized representative, whether or not enrolled to practice must also comply with the conference and practice requirements of the Statement of Procedural Rules (26 CFR 601). Form 2848, Power of Attorney, and Form 2848-D, Authorization and Declaration, may be used with regard to rulings, closing agreements, and determination letters requested under this revenue procedure.

.11 If a taxpayer has more than one representative, it is sufficient to send a copy of the ruling to any one of them. Copies of a ruling will be sent to no more than two representatives, provided that they are located at different mailing addresses. If a taxpayer does not designate which representative is to receive a copy of the ruling, a copy of the ruling will be sent to the first representative named on the latest power of attorney. If the original of the ruling is to be sent to a representative, the power of attorney should contain a statement to that effect and designate the mailing address of the representative.

.12 A request for a ruling letter by the National Office should be sent to the Internal Revenue Service, Associate Chief Counsel (Technical and International), Attention CC:IND:D:C, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044. Requests may be hand delivered to Room, 6561, 1111 Constitution Avenue, N.W., Washington, DC 20224. A request for a determination letter should be sent to the District Director of Internal Revenue whose office has or will have examination jurisdiction over the taxpayer's return.

.13 If a request for a ruling or determination letter does not comply with all the provisions of this revenue procedure, the request will be acknowledged, and the requirements that have not been met will be pointed out. If a request for a ruling lacks essential information, the taxpayer will be told that if the information is not received within 30 calendar days, the request will be closed. If the information is received after the request is closed, it will be reopened and treated as a new request as of the date the essential information is received. A request for a ruling letter sent to the District Director that does not comply with the provisions of this revenue procedure will be returned by the District Director for corrections before it is sent directly to the National office.

.14 A taxpayer who wants to have a conference on the issue or issues involved should indicate this in writing when, or soon after, filing the request.

.15 The Service processes requests for ruling and determination letters in regular order and as expeditiously as possible. Consideration of a request for processing ahead of its regular order, or by a specified time, delays the processing of other matters. Requests for processing ahead of the regular order must be made in writing, preferably in a separate letter sent with, or soon after, the request. If the request is not made in a separate letter, then the letter in which the request is made should say, at the top of the first page: "Expeditious Handling Is Requested. See page __ of this letter." The request should give a compelling need for such treatment. The Service cannot give assurance that any letter will be processed by the time requested. For example, the scheduling of a closing date for a transaction or a meeting of the board of directors or shareholders of a corporation, without regard for the time it may take to obtain a ruling or determination letter, will not be considered sufficient reason for handling a request ahead of its regular order. Nor will the possible effect of fluctuation in the market price of stocks on a transaction be considered sufficient reason for handling a request out of order. Requests by telegram will be treated in the same manner as requests by letter. Ruling and determination letters ordinarily are not issued by telegram. A request for expeditious handling will not cause the Communications and Records Unit to route the case to the Ruling Branch ahead of normal-processing; and a request for expeditious handling will not be considered until the underlying ruling request has been found to satisfy the section 6110 requirements.

.16 The Director, Individual Tax Division, has primary responsibility for providing basic principles for uniform interpretation and application of the federal tax laws in those areas involving: income taxes of subchapter S corporations (except accounting periods and methods) and noncorporate taxpayers (including individuals, partnerships, estates, and trusts); political organizations under section 527 (except subsection (f)); employment taxes and taxes on self-employment income; estate, gift, generation-skipping transfer, and certain excise taxes; and procedure and administration provisions of the Internal Revenue Code, except those that apply specifically to employee plans, exempt organizations, and actuarial determinations.

.17 The Director, Corporation Tax Division, has primary responsibility for providing basic principles of and rules for uniform interpretation and application of the federal tax laws in those areas involving: income taxes and earnings and profits of corporate taxpayers; changes in methods and periods of accounting, depreciation, depletion, valuation, and other engineering issues; the taxable status of exchanges and distributions in connection with corporate organizations, reorganizations, and liquidations; and the exemption of farmers' cooperatives (under section 521), shipowners' protection and indemnity associations (under section 526), and certain homeowners associations (under section 528).

.18 The Director, Employee Benefits and Exempt Organizations Division, has primary responsibility for providing basic principles for uniform interpretation and application of the federal tax laws in those areas involving: income tax and other tax aspects of executive compensation and employee benefit programs (other than those within the jurisdiction of the Assistant Commissioner (Employee Plans and Exempt Organizations)); and employment taxes and taxes on self-employment income.

.19 A taxpayer may obtain information regarding the status of a request by calling the person whose name and telephone number is shown on the acknowledgment of receipt of the request.

.20 After receiving the notice under section 6110(f)(1) of the Code of intention to disclose the ruling or determination letter (including a copy of the version proposed to be open to public inspection and notation of third-party communications under section 6110(d)), the person requesting the ruling or determination letter may protest the disclosure of certain information in the ruling or determination letter. That person must within 20 calendar days send a written statement to the Internal Revenue Service office indicated on the notice of intention to disclose identifying those deletions that the Service has not made and that the person requesting the ruling or determination letter believes should have been made. That person must also submit a copy of the version of the ruling or determination letter proposed to be open to public inspection on which the person indicates, by use of brackets, the deletions proposed by the taxpayer that have not been made by the Service. Generally, the Service will not consider the deletion under this subparagraph of any material that the taxpayer did not propose to be deleted before the ruling or determination letter was issued. Within 20 days after it receives the response to the notice under section 6110(f)(1), the Service will mail to that person its final administrative conclusion regarding the deletions to be made. The taxpayer does not have the right to a conference to resolve any disagreements concerning material to be deleted from the text of the ruling. However, these matters may be taken up at any conference that is otherwise scheduled regarding the request.

.21 After receiving the notice under section 6110(f)(1) of the Code of intention to disclose (but not later than 60 calendar days after the notice is mailed), the person requesting a ruling or determination letter may send a request for delay of public inspection under either section 6110(g)(3) or (4). The request for delay must be sent to the Internal Revenue Service office indicated on the notice of intention to disclose. A request for delay under section 6110(g)(3) must contain the date on which it is expected that the underlying transaction will be completed. The request for delay under section 6110(g)(4) must contain a statement from which the Commissioner may determine that there are good reasons for the delay.

.22 A taxpayer who receives a ruling or determination letter before filing a return about any transaction that has been consummated and that is relevant to the return being filed should attach a copy of the ruling or determination letter to the return when it is filed.

.23 For appeal procedures with regard to adverse determination letters under section 521 of the Code and revocation or modification of exemption rulings and determination letters under section 521, see Rev. Proc. 84-46, 1984-1 C.B. 541, as amplified by Rev. Proc. 84-47, 1984-1 C.B. 545, and modified by Rev. Proc. 85-32, 1985-2 C.B. 415.

.24 In those situations when the National Office believes that the taxpayer's representative is not in compliance with Treasury Department Circular No. 230, the National Office will bring the matter to the attention of the Director of Practice.

SEC. 9. HANDLING OF RULING REQUESTS

.01 Within 21 calendar days after a ruling request is received in the Branch, Service personnel will contact the taxpayers to discuss informally the procedural and substantive issues in the ruling request.

.02 The following subject matters are included in the 21 calendar day procedure:

1. Individual Tax Division

(a) Partnerships and trusts

(b) Real estate investment trusts

(c) Credit for employment of certain new employees

(d) Estate and gift taxes

(e) Tax-exempt obligations

(f) Charitable remainder trusts

(g) Pooled income funds

best copy available

(h) Administrative provisions of the Code

(i) Excise taxes

(j) Installment sales

2. All matters within the jurisdiction of the Corporation Tax Division, except cases

(a) involving a request for change in accounting methods or periods, generally governed by Rev. Proc. 84-74, 1984-2 C.B. 736.

(b) relating to the last-in, first-out method of computing inventory.

(c) concerning insurance, issues on contracts with reserves based on segregated asset accounts.

(d) concerning insurance issues requiring actuarial computations.

3. Employee Benefits and Exempt Organizations Division

(a) Stock options

(b) Employment and self-employment taxes (except ruling requests from individuals for employment status submitted on Forms SS-8)

(c) Rental value of parsonages

.03 Procedures to be followed regarding ruling requests are:

1. Within 21 calendar days after a ruling request has been received in the Branch having jurisdiction, a representative of the Branch will contact the taxpayer to discuss the procedural issues in the ruling requests covered by this procedure. Considering the complexity of some cases or the number of issues involved, it may not be possible for the Branch representative to discuss the substantive issues in the ruling request during this initial contact. However, when possible, as to each issue coming within the jurisdiction of the Branch, the Branch representative will tell the taxpayer:

(a) whether the Branch representative will recommend the Service rule as the taxpayer requested, rule adversely on the matter, or not rule;

(b) whether the taxpayer should submit additional information or representations to enable the Service to rule on the matter; or

(c) whether because of the nature of the transaction, or the issue presented, a tentative conclusion on the issue cannot be reached.

2. When the rulings requested involve matters within the jurisdiction of more than one Branch, a representative of the Branch that received the original ruling request will tell the taxpayer wihin the initial 21-calendar-day contact period: (1) that the rulings requested involving matters within the jurisdiction of another Branch have been referred to the other Branch for consideration, and (2) that a representative of the other Branch will contact the taxpayer within 21 calendar days after receiving the referral to informally discuss the procedural and, to the extent possible, the substantive issues if covered by this procedure.

3. If something less than a fully favorable ruling is indicated, the Branch representative will tell the taxpayer if minor modifications of the transaction or adherence to certain published positions will warrant the issuance of a favorable ruling. In addition, the Branch representative may tell the taxpayer what representations must be furnished in a document to comply with the requirements of the Service. However, the Branch representative will not suggest precise changes that would materially alter the form of the proposed transaction. If, at the conclusion of the discussion, the Branch representative determines that a meeting in the National Office would better serve the purpose of developing or exchanging information, a meeting will be offered and an early meeting date arranged. This meeting will not be the taxpayer's conference of right, as described in this revenue procedure.

4. The Service will not be bound by the informal opinion expressed by the Branch representative or any other authorized Service representative under this procedure, and such an opinion cannot be relied upon as a basis for obtaining retroactive relief under the provisions of section 7805(b) of the Code.

5. The ruling request will then be processed under present procedures.

SEC. 10. CONFERENCES IN THE NATIONAL OFFICE

.01 A taxpayer may request a conference only in connection with a ruling request. Normally, a conference is scheduled only when the National Office considers it to be helpful in deciding the case or when an adverse decision is indicated. If conferences are being arranged for more than one request for a ruling involving the same taxpayer, they will be scheduled so as to cause the least inconvenience to the taxpayer. If a conference has been requested, the taxpayer will be notified by telephone, if possible, of the time and place of the conference. The conference must be held within 21 calendar days after such contact has been made. Procedures for requesting an extension of the 21-day period and notifying the taxpayer or the taxpayer's representative of the Service's decision are the same as those stated in section 8.05.

.02 A taxpayer is entitled, as a matter of right, to only one conference in the National Office unless one of the circumstances discussed in section 10.06 develops. This conference normally will be held at the Branch level of the appropriate Division in the office of the Associate Chief Counsel (Technical and International) and will be attended by a person who, at the time of the conference, has authority to sign the ruling letter for the Branch Chief in the case being discussed. When more than one Branch has taken an adverse position of an issue within its jurisdiction presented in a ruling request, or when the position ultimately adopted by one Branch will affect another Branch's determination, a representative from each Branch with the authority to sign for the Branch Chief will attend the conference. If more than one subject is to be discussed at the conference, the discussion will constitute a conference on each subject. In order to promote a free and open discussion of the issues, the conference usually will be held after the Branch has had an opportunity to study the case. However, at the request of the taxpayer or representative, the conference of right may be held at an earlier stage in the consideration of the case than the Service ordinarily would designate. No taxpayer has a "right" to appeal the action of a Branch to a Division Director or to any other official of the Service.

.03 In employment tax matters, only the party entitled to the ruling is entitled to a conference

.04 Since conference procedures are informal, no tape, stenographic, or other verbatim recording of a conference will be made

.05 The senior Service representative present at the conference insures that the taxpayer has full opportunity to present views on all of the issues that are in question. The Service representative explains the Service's tentative decision on the substantive issues and the reason for that decision. If the taxpayer advances prospective application under section 7805(b) of the Code, the Service representative will discuss the tentative recommendation concerning the request for relief and the reason for the tentative recommendation. No commitment will be made as to the conclusion that the Service will finally adopt.

.06 An invitation to an additional conference will be extended if, after the conference of right, an adverse holding is proposed but on a new issue or on the same issue but on different grounds from those discussed at the first conference. There is no right to another conference when a proposed holding is reversed at a higher level with a result less favorable to the taxpayer if the ground or arguments on which the reversal is based were discussed at the conference of right. The provision of this revenue procedure limiting the number of conferences to which a taxpayer is entitled will not prevent a taxpayer from attending further conferences when, in the opinion of National Office personnel, such conferences are necessary. All additional conferences of the type discussed in this paragraph are held only at the invitation of the Service.

.07 It is the responsibility of the taxpayer to furnish in writing to the National Office any additional data, lines of reasoning, precedents, etc., that are proposed by the taxpayer and discussed at the conference but that were not previously or adequately presented in writing. The taxpayer must furnish the additional information within 21 calendar days. If the additional information is not received within that time, a ruling will be issued on the basis of the information on hand or, if appropriate, no ruling will be issued. Procedures for requesting an extension of the 21-day period and notifying the taxpayer or the taxpayer's representative of the Service's decision are the same as those stated in section 8.05.

SEC. 11. DISTRICT OFFICE REFERRAL OF MATTERS TO THE NATIONAL OFFICE

.01 Request for determination letters received by District Directors that, under the provisions of this revenue procedure, may not be acted upon by a District Office, will be forwarded to the National Office for reply. The District Office will let the taxpayer know that this action has been taken. District Directors will also refer to the National Office any request for a determination letter that in their judgment should have the attention of the National Office.

.02 If the request involves an issue on which the Service will not issue a ruling or determination letter, the request will not be forwarded to the National Office. The District Office will let the taxpayer know that the Service will not issue a ruling or a determination letter on the issue. See section 7.01 of this revenue procedure.

SEC. 12. REFERRAL OF MATTERS TO DISTRICT OFFICES

Request for rulings received by the National Office that, under section 5 of this revenue procedure, may not be acted upon by the National Office will be forwarded to the District Office that has examination jurisdiction over the taxpayer's return. The taxpayer will be notified of this action. If the request is on an issue or in an area of the type discussed in section 7.01 and it is decided not to issue a ruling or an information letter, the National Office will let the taxpayer know and the request will then be forwarded to the appropriate District Office for association with the related return.

SEC. 13. REVIEW OF DETERMINATION LETTERS

Determination letters issued under sections 6.01, 6.02, 6.03, and 6.04 are not reviewed by the National Office before they are issued. If a taxpayer believes that a determination letter of this type is in error, the taxpayer may ask the District Director to reconsider the matter. The taxpayer may also ask the District Director to request technical advice from the National Office. In such an event the procedures in Rev. Proc. 88-2 must be followed.

SEC. 14. WITHDRAWAL OF REQUESTS

A request for a ruling or determination letter may be withdrawn at any time before the signing of the letter of reply. If a request for a ruling is withdrawn, the National Office may give its views on the subject matter of the request to the District Director whose office will have examination jurisdiction over the taxpayer's return for consideration in connection with any later examination of the taxpayer's return. Even though a request is withdrawn, all correspondence and exhibits will be kept by the Service and will not be returned to the taxpayer. In appropriate cases, the Service may publish its findings in a revenue ruling or revenue procedure.

SEC. 15. ORAL ADVICE TO TAXPAYERS

.01 The Service does not issue rulings or determination letters on oral requests. However, personnel in the rulings divisions ordinarily will discuss with taxpayers or their representatives inquiries regarding: substantive tax issues; whether the Service will rule on particular issues; and questions relating to procedural matters about submitting ruling requests (including the application of section 8, of this revenue procedure, to a particular case). Any discussion of substantive issues will be at the discretion of the Service on a time-available basis, and will not be binding on the Service.

.02 A taxpayer may seek oral technical assistance from a Taxpayer Service Representative in a District Office or Service Center when preparing a return or report, under other established procedures. Oral advice is advisory only and the Service is not bound to recognize it in the examination of the taxpayer's return.

SEC. 16. EFFECT OF RULINGS

.01 A taxpayer may not rely on a ruling issued to another taxpayer. A ruling, except to the extent incorporated in a closing agreement, may be revoked or modified at any time under appropriate circumstances. See section 4.08 for the effect of a closing agreement. If a ruling is revoked or modified, the revocation or modification applies to all years open under the statutes, unless the Commissioner or the Commissioner's delegate exercises the discretionary authority under section 7805(b) of the Code to limit the retroactive effect of the revocation or modification. The manner in which the authority generally is exercised is given later in this section. For information on rulings relating to the sale or lease of articles subject to the manufacturer's excise tax and the retailer's excise tax, see section 16.08.

.02 When determining a taxpayer's liability, the District Director must ascertain whether (1) any ruling previously issued to the taxpayer has been properly applied, (2) the representations upon which the ruling was based reflected an accurate statement of the material facts, and (3) the transaction actually was carried out substantially as proposed. If, in the course of determining the tax liability, the District Director finds that a ruling should be modified or revoked, the findings and recommendations of the District Director will be forwarded to the National Office for consideration before further action. Such a referral to the National Office will be treated as a request for technical advice and the procedures of Rev. Proc. 88-2 will be followed. Otherwise, the ruling is to be applied by the District Office in its determination of the taxpayer's liability.

.03 Appropriate coordination with the National Office will be undertaken if any field official having jurisdiction over a return or other matter proposes to reach a conclusion contrary to a ruling previously issued to the taxpayer.

.04 Except to the extent incorporated in a closing agreement, a ruling found to be in error or not in accord with the current views of the Service may be modified or revoked. Modification or revocation of a ruling may be made by (1) a notice to the taxpayer to whom the ruling was issued, (2) an enactment of legislation or ratification of a tax treaty, (3) a decision of the United States Supreme Court, (4) the issuing of temporary or final regulations, or (5) the issuing of a revenue ruling, a revenue procedure, or other statement published in the Internal Revenue Bulletin. Consistent with these provisions, if a ruling relates to a continuing action or a series of actions, the ruling will ordinarily be applied until any one of the actions described above has taken place, or until specifically withdrawn. Publication of a notice of proposed rulemaking will not affect the application of any ruling issued under the procedures stated in this revenue procedure.

.05 Except in rare or unusual circumstances, the revocation or modification of a ruling will not be applied retroactively to the taxpayer for whom the ruling was issued or to a taxpayer whose tax liability was directly involved in the ruling if (1) there has been no misstatement or omission of material facts, (2) the facts at the time of the transaction are not materially different from the facts on which the ruling was based, (3) there has been no change in the applicable law, (4) the ruling was originally issued with respect to a prospective or proposed transaction, and (5) the taxpayer directly involved in the ruling acted in good faith in reliance upon the ruling and the retroactive revocation would be to the taxpayer's detriment. For example, the tax liability of each shareholder is directly involved in a ruling on the reorganization of a corporation. However, the tax liability of members of an industry is not directly involved in a ruling issued to one of the members, and the holding in a revocation or modification of a ruling to one member of an industry may be retroactively applied to other members of the industry. By the same reasoning, a tax practitioner may not obtain the nonretroactive application to one client of a modification or revocation of a ruling previously issued to another client. If a ruling is revoked by letter with retroactive effect, the letter will, except in fraud cases, state the grounds upon which the revocation is being made and the reasons why the revocation is being applied retroactively.

.06 A ruling issued on a particular transaction represents a holding of the Service on that transaction only. However, the application of that ruling to the transaction will not be affected by the later issuing of regulations (either temporary or final), if the conditions specified in section 16.05 are met. If the ruling is later found to be in error or no longer in accord with the position of the Service, it will not give the taxpayer protection for a like transaction in the same year or later year.

.07 However, if a ruling is issued covering a continuing action or a series of actions and it is determined that the ruling was in error, or no longer in accord with the position of the Service, the Associate Chief Counsel (Technical and International) ordinarily will limit the retroactivity of the revocation or modification to a date that is not earlier than that on which the ruling is modified or revoked. To illustrate, if a taxpayer receives a ruling that certain payments are excludable from gross income for federal income tax purposes and it is later determined that the ruling is in error or no longer in accord with the position of the Service, the Associate Chief Counsel (Technical and International) ordinarily will restrict the retroactive application of the revocation or modification of the ruling. If a taxpayer rendered service or provided a facility that is subject to the excise tax on services or facilities, and in reliance on a ruling issued to the same taxpayer did not pass the tax on to the user of the service of the facility, the Associate Chief Counsel (Technical and International) ordinarily will restrict retroactive application of the revocation or modification of the ruling. If an employer incurred liability under the Federal Insurance Contributions Act, but in reliance on a ruling made to the same employer, neither collected the employee tax nor paid the employee and employer taxes under the Act, the Associate Chief Counsel (Technical and International) ordinarily will restrict the retroactive application of the revocation or modification of the ruling for both the employer tax and the employee tax. In the last situation, however, the restriction of retroactive application ordinarily will be conditioned on the furnishing by the employer of wage data, as may be required by section 31.6011(a)-1 of the Employment Tax Regulations.

.08 A ruling holding that the sale or lease of a particular article is subject to the manufacturer's excise tax or the retailer's excise tax may not retroactively revoke or modify an earlier ruling holding that the sale or lease of such an article was not taxable, if the taxpayer to whom the ruling was issued, in reliance upon the earlier ruling, parted with possession or ownership of the article without passing the tax on to the customer. Section 1108(b), Revenue Act of 1926.

.09 For rulings involving completed transactions, other than those described in sections 16.07 and 16.08, taxpayers will not be given the protection against retroactive revocation provided in section 16.05, since they will not have entered into the transactions in reliance on the ruling.

SEC. 17. EFFECT OF DETERMINATION LETTERS

A determination letter issued by a District Director has the same effect as a ruling issued to a taxpayer under section 16 of this revenue procedure. However, if the District Director is of the opinion that a conclusion contrary to that expressed in the determination letter is indicated, the matter need not be referred to the National Office. A District Director may not limit the modification or revocation of a determination letter but may refer the matter to the National Office for the possible exercise by the Commissioner or the Commissioner's delegate of the authority to limit the modification or revocation.

SEC. 18. EFFECT OF INFORMATION LETTERS

An information letter used by the National Office or by a District Director is advisory only and the provisions of section 16 do not apply.

SEC. 19. PROCEDURE FOR REQUESTING APPLICATION OF SECTION 7805(b) IN THE CASE OF RULINGS AND DETERMINATION LETTERS

.01 Pursuant to section 7805(b) of the Code, it is within the discretion of the Commissioner or the Commissioner's delegate to prescribe the extent, if any, to which any ruling (including determination letters) will be applied without retroactive effect.

A taxpayer to whom a ruling or determination letter has been issued may request that the Associate Chief Counsel (Technical and International), or the Commissioner's delegate, exercise the discretionary authority under section 7805(b) of the Code to limit the retroactive effect of any subsequent revocation or modification of the ruling or determination letter.

.02 In the case of a ruling, a request to limit the retroactive effect of the revocation or modification of a ruling must be in the form of, and meet the requirements for, a ruling request generally. These requirements are set forth in section 8 of this revenue procedure. Specifically, the request must state that it is being made pursuant to section 7805(b), contain a statement of the relief sought and an explanation of the reasons and arguments in support of the relief requested, and also be accompanied by any documents bearing on the request. The explanation in support of the application of section 7805(b) should include a discussion of the five items enumerated in section 16.05 of this revenue procedure as they relate to the taxpayer's particular situation.

A request for the application of section 7805(b) of the Code may take the form of a separate request for a ruling when, for example, a revenue ruling has the effect of modifying or revoking a ruling previously issued to the taxpayer or when the Service notifies the taxpayer of a change in position that will have the effect of revoking or modifying such a ruling. However, when such notice is given by the District Director during the course of an examination of the taxpayer's return, or during consideration by the Chief, Appeals Office, a request to limit the retroactive effect of the modification or revocation of a ruling must be made in the form of a request for technical advice. See section 12.03 of Rev. Proc. 88-2. When germane to a pending ruling request, a request for the application of section 7805(b) may be made as part of the request, either intially or at any time before the ruling is issued. When a ruling that concerns a continuing transaction is modified or revoked by, for example, a subsequent revenue ruling, a request to limit the retroactive effect of the modification or revocation of the ruling must be made before the return is examined that contains the transaction that is the subject of the request for a ruling.

.03 When a request for the application of section 7805(b) of the Code is made in a separate ruling request, the taxpayer has the right to a conference in the National Office in accordance with the provisions of section 10 of this revenue procedure. If the request is made intially as part of a pending ruling request or is made before the conference of right is held on the substantive issues, the section 7805(b) issue will be discussed at the taxpayer's one conference of right. (See section 10.05 of this revenue procedure). If the request for the application of section 7805(b) is made as part of a pending ruling request after a conference has been held on the substantive issue, and the Service determines that there is justification for having delayed the request, then the taxpayer will have the right to one conference of right concerning the application of section 7805(b) with the conference limited to discussion of this issue.

.04 In the case of a determination letter that the District Director proposes to modify or revoke, a request to limit the modification or revocation of the determination letter must be made by requesting the District Director who issued the determination letter to seek technical advice from the National Office, since a District Director has not been delegated authority under section 7805(b) of the Code to limit the modification or revocation of a determination letter. See section 12.03 of Rev. Proc. 88-2. The taxpayer's request must state that it is being made pursuant to section 7805(b), contain a statement of the relief sought and an explanation of the reasons and arguments in support of the relief requested, and also be accompanied by any documents bearing on the request. The explanation in support of the application of section 7805(b) should include a discussion of the five items enumerated in section 16.05 of this revenue procedure as they relate to the taxpayer's particular situation.

.05 When technical advice is requested with respect to the application of section 7805(b) of the Code under the circumstances set forth in section 19.04 above, the taxpayer has a right to a conference in the National Office to the same extent as does any taxpayer who is the subject of a technical advice request. See section 8 of Rev. Proc. 88-2.

SEC. 20. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 87-1 is superseded. Rev. Proc. 87-7, 1987-1 C.B. 542, which modified Rev. Proc. 87-1 is not superseded.

---

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement, determination of correct tax liability.

Rev. Proc. 88-2

CONTENTS

- SECTION 1. PURPOSE
- SECTION 2. SCOPE
  - .01 Jurisdiction
  - .02 Delegation
- SECTION 3. CHANGES
- SECTION 4. DEFINITION AND NATURE OF TECHNICAL ADVICE
  - .01 Taxpayer
  - .02 National Office
  - .03 District Director
  - .04 Technical Advice
  - .05 Section 521 of the Code
  - .06 Revocation of ruling letter
  - .07 When technical advice can be requested
- SECTION 5. REQUESTING TECHNICAL ADVICE
  - .01 Responsibility
  - .02 Taxpayer notified
  - .03 Taxpayer agreement
  - .04 Service agreement
  - .05 Taxpayer's position
  - .06 Taxpayer's right to conference
  - .07 Time to make proposed section 6110 deletions
  - .08 Section 6104 of the Code
  - .09 Section 6110 deletion statement
  - .10 Criminal or civil fraud cases
  - .11 Section 1.9100-1 of the Income Tax Regulations
  - .12 Form 4463
  - .13 Power of attorney
- SECTION 6. APPEAL BY TAXPAYERS OF DISTRICT OR APPEALS OFFICE DETERMINATION NOT TO SEEK TECHNICAL ADVICE
  - .01 Taxpayer notification
  - .02 Taxpayer appeal
  - .03 Appeals Office statement
  - .04 Review of appeal
- SECTION 7. WITHDRAWAL OF REQUESTS
  - .01 Taxpayer notification
  - .02 National Office views
- SECTION 8. CONFERENCES IN THE NATIONAL OFFICE
  - .01 Scheduling
  - .02 One conference of right
  - .03 Conference delayed to address together the substantive issues and request for section 7805(b) relief
  - .04 No tape or other verbatim recording
  - .05 Tentative recommendations
  - .06 Additional conferences
  - .07 Post conference submissions
  - .08 Status request by taxpayer
  - .09 Status request by the District Director or Chief, Appeals Office
- SECTION 9. PREPARATION OF TECHNICAL ADVICE MEMORANDUM BY THE NATIONAL OFFICE
  - .01 Analyze file
  - .02 Branch representative informs district office that either
    - (a) case being returned
    - (b) additional information needed
    - (c) tentative conclusion given, or
    - (d) date estimated for tentative conclusion
  - .03 Branch representative contact with district office
  - .04 District or Appeals Office advised that preliminary conclusion not final
  - .05 Multiple issue request
  - .06 Request for additional information
  - .07 Copy of additional information sent to District Director or Chief, Appeals Office
  - .08 Deleted material
  - .09 Form and routing of replies
  - .10 When copy of technical advice given to taxpayer
  - .11 Protest under section 6110 of the Code
- SECTION 10. ACTION ON TECHNICAL ADVICE IN DISTRICT AND APPEALS OFFICES
  - .01 Processing of the case
  - .02 Copy to the taxpayer
  - .03 No copy to the taxpayer
- SECTION 11. EFFECT OF TECHNICAL ADVICE
  - .01 Retroactive effect
  - .02 Modification or revocation of prior technical advice
  - .03 Continuing or series of actions—how modified or revoked
  - .04 Conditions for nonretroactivity
- SECTION 12. PROCEDURES FOR REQUESTING APPLICATION OF SECTION 7805(b) IN THE CASE OF TECHNICAL ADVICE
  - .01 Application of section 7805 (b) of the Code
  - .02 Form of request to limit retroactivity before a return is filed—continuing transaction
  - .03 Form of request to limit retroactivity during course of an examination
  - .04 Form of request to limit retroactivity—technical advice that does not modify or revoke prior memorandum
  - .05 Taxpayer's right to conference
- SECTION 13. EFFECT ON OTHER DOCUMENTS

SECTION 1. PURPOSE

The purpose of this revenue procedure is to update Rev. Proc. 87-2, 1987-1 C.B. 515, which provides revised procedures for furnishing technical advice to District Directors and Chiefs, Appeals Offices, by the Associate Chief Counsel (Technical and International). It also tells taxpayers about their rights when a District Director or a Chief, Appeals Office, requests such advice. Changes to this revenue procedure will be incorporated annually in a new revenue procedure published as the second revenue procedure of the year.

SEC. 2. SCOPE

.01 The Chief Counsel through the Associate Chief Counsel (Technical and International) provides principles and rules for uniformly interpreting and applying the federal tax laws under the jurisdiction of the Associate Chief Counsel (Technical and International). However, the procedures for obtaining technical advice on specific issues involving the interpretation or application of the federal income tax laws and income tax treaties relating to international transactions are not contained in this revenue procedure but are contained in Rev. Proc. 87-5, 1987-1 C.B. 535.

The procedures for obtaining technical advice specifically applicable to federal firearms, alcohol and tobacco laws under subtitle E of the Internal Revenue Code are under the jurisdiction of the Bureau of Alcohol, Tobacco and Firearms. The procedures for obtaining technical advice specifically on issues under the jurisdiction of the Assistant Commissioner (Employee Plans and Exempt Organizations) are found in Rev. Proc. 80-26, 1980-1 C.B. 671. The procedures that apply to technical advice for employee plans and exempt organizations are followed in obtaining technical advice on exemption of farmers' cooperatives from tax under section 521 of the Code, even though the Associate Chief Counsel (Technical and International) has jurisdiction for issuing technical advice under this section. The Associate Chief Counsel (Technical and International) also has the jurisdiction for issuing technical advice under section 526, on shipowners' protection and indemnity associations; section 527(a), (b), (c), (d), (e), and (g), on political organizations; and section 528, on certain homeowners associations, under this revenue procedure.

.02 In the Office of the Associate Chief Counsel (Technical and International), the authority to issue technical advice has been largely redelegated to the Branch Chiefs in the Individual Tax Division, the Corporation Tax Division, and the Employee Benefits and Exempt Organizations Division.

SEC. 3. CHANGES

.01 References throughout the revenue procedure to the Associate Chief Counsel (Technical) are changed to the Associate Chief Counsel (Technical and International) to reflect the combination of the Technical and International organizations under one Associate Chief Counsel.

.02 Section 2.02 is amended to refer to the Employee Benefits and Exempt Organizations Division in addition to the Corporation Tax Division and the Individual Tax Division.

.03 Section 8.01 is amended to provide that an extension of the 21-day period for conferences must be approved by the Associate Director or Deputy Associate Director having jurisdiction over the Branch to which the case is assigned.

.04 Section 8.02 is amended to refer to the Employee Benefits and Exempt Organizations Division in addition to the Corporation Tax Division and the Individual Tax Division.

.05 Section 8.07 is amended to provide that an extension of the 21-day period for post-conference submissions must be approved by the Associate Director or Deputy Associate Director having jurisdiction over the Branch to which the case is assigned.

SEC. 4. DEFINITIONS AND NATURE OF TECHNICAL ADVICE

.01 For purposes of this revenue procedure, the word "taxpayer" includes all persons subject to any provision of the Internal Revenue Code and, when appropriate, their representatives and issuers of section 103 obligations.

.02 Any reference to the National Office means only the Office of the Associate Chief Counsel (Technical and International).

.03 Any reference to District Director or District Office includes the office of the Director of the Foreign Operations District, where appropriate. Any reference to Chief, Appeals Office, includes Associate Chief, Appeals Office.

.04 "Technical advice" means advice or guidance furnished by the National Office upon requests of a District or an Appeals Office in response to any technical or procedural question that develops during any stage of any proceeding on the interpretation and proper application of tax law, tax treaties, regulations, revenue rulings, or other precedents published by the National Office to a specific set of facts. Such proceedings include (1) the examination of a taxpayer's return, (2) consideration of a taxpayer's claim for refund or credit, or (3) any other matter involving a specific taxpayer under the jurisdiction of the Chief, Examination Division, such as the consideration of a taxpayer's application to enter into an agreement about the useful life method, and rate of depreciation of business property provided by section 167(d) of the Code. These proceedings include an examination to determine whether obligations issued are described in section 103(a). They also include processing and considering nondocketed cases in an Appeals Office. Technical advice is furnished as a way of helping Service personnel close cases and establish and maintain consistent holdings throughout the Internal Revenue Service. A District Director or an Appeals Office may raise an issue in any tax period, even though technical advice may have been asked for and furnished for the same or a similar issue for another tax period. Technical advice does not include memoranda on matters of general technical application furnished to District or Appeals Offices when the issues are not raised in connection with a proceeding involving a specific taxpayer.

.05 If a District Director, Chief, Appeals Office, or a taxpayer requests technical advice on a determination letter under section 521 of the Code, the procedures under Rev. Proc. 80-26, 1980-1 C.B. 671, and Rev. Proc. 84-46, 1984-1 C.B. 541, as well as section 601.201(n) of the Statement of Procedural Rules, must be followed.

.06 Only the National Office can revoke a ruling letter. Therefore, if a District Director or a Chief, Appeals Office, thinks that a ruling letter previously issued to a taxpayer should be modified or revoked, the procedures in section 5 of this revenue procedure must be followed.

.07 The provisions of this revenue procedure apply only to a case under the jurisdiction of a District Director or Chief, Appeals Office. Technical advice may be requested on issues considered in a prior Appeals disposition, not based on mutual concessions for the same tax period of the same taxpayer, if the Appeals Office that had the case concurs in the request. A District Director may not request technical advice on an issue if an Appeals Office is currently considering an identical issue of the same taxpayer (or of a related taxpayer within the meaning of section 267 of the Code or a member of an affiliated group of which the taxpayer is also a member within the meaning of section 1504). A case remains under the jurisdiction of the District Director even though an Appeals Office has the identical issue under consideration in the case of another taxpayer (not related within the meaning of sections 267 and 1504, respectively) in an entirely different transaction. With respect to the same taxpayer or the same transaction, when the issue is under the jurisdiction of an Appeals Office, and the applicability of more than one kind of tax is dependent upon the resolution of that issue, a District Director may not request technical advice on the applicability of any of the taxes involved.

SEC. 5. REQUESTING TECHNICAL ADVICE

.01 The District Director or Chief, Appeals Office is responsible for determining whether to request technical advice on any issue being considered. Each request must be submitted through channels and signed by a person who is authorized to sign for the District Director or Chief, Appeals Office, and should include, in writing, a statement of applicable law and the arguments submitted by the District or Appeals Office in support of its position on the issue or issues. All requests for technical advice from Appeals Offices should be submitted to Associate Chief Counsel (Technical and International) through the Director, Appeals Division, CC:AP:PT. However, while the case is under the jurisdiction of the District Director or the Chief, Appeals Office, a taxpayer may request that an issue be referred to the National Office for technical advice. All requests for technical advice should be made at the earliest possible stage of the proceedings. The grounds for a request are that a lack of uniformity exists on the disposition of the issue or that the issue is unusual or complex enough to warrant consideration by the National Office. Taxpayers may also request technical advice when seeking an extension of time fixed by regulations for making an election or application for relief pursuant to section 1.9100-1 of the Income Tax Regulations. See section 5.11 of this revenue procedure for additional information. Although taxpayers are encouraged to make written requests setting forth the facts, law, and argument on the issue, and reasons for requesting National Office technical advice, they may make the request orally. If, after considering the taxpayer's request, the examining officer or Appeals Officer thinks that the circumstances do not warrant referral of the case to the National Office, the examining officer or Appeals Officer will tell the taxpayer. (See section 6 for taxpayer's appeal rights when an examining officer or an Appeals Officer declines to request technical advice).

.02 When technical advice is going to be requested, whether or not on the request of the taxpayer, the taxpayer will be told about it and given a copy of the arguments submitted by the District Director or Chief, Appeals Office, in support of its position on the issue or issues, except as noted in section 5.10. If the examining Officer or the Appeals Officer initiates the action, the Service will give the taxpayer a copy of the statement of the pertinent facts and the questions proposed for submission to the National Office. The request for technical advice should be worded to avoid possible misunderstanding in the National Office of the facts or the specific points at issue.

.03 If the Service initiates the request for technical advice, the taxpayer has 10 calendar days after receiving the statement of facts and specific questions to indicate in writing any disagreement about them. The taxpayer must justify in writing an extension of time beyond the 10 calendar days. The justification must be approved by the Chief, Examination Division, or the Chief, Appeals Office. Every effort should be made to reach agreement on the facts and the specific points at issue. If agreement cannot be reached, the taxpayer may send, within 10 calendar days after receipt of notice, a statement of the taxpayer's understanding of the new specific points at issue. This statement will be forwarded to the National Office with the request for technical advice. The taxpayer must justify in writing an extension of time beyond the 10 calendar days. The justification must be approved by the Chief, Examination Division, or the Chief, Appeals Office. When the District Director or the Chief, Appeals Office and the taxpayer cannot agree on material facts, the National Office, at its discretion, may refuse to provide technical advice.

.04 If the taxpayer initiates the action to request technical advice and the taxpayer's statement of the facts and points at issue is not wholly acceptable to the District or Appeals Office, the Service will tell the taxpayer in writing what the areas of disagreement are. The taxpayer has 10 calendar days after receiving the written notice to reply to it. The taxpayer must justify in writing an extension of time beyond the 10 calendar days. The justification must be approved by the Chief, Examination Division or the Chief, Appeals Office. If agreement cannot be reached, both the statements of the taxpayer and the District or Appeals Office will be forwarded to the National Office with the request for technical advice. When the disagreement involves material facts essential to the preliminary assessment of the case, the District Director or Chief, Appeals Office, may, at its discretion, refuse referral to the National Office of a taxpayer initiated request for technical advice or, alternatively, the National Office may refuse to provide technical advice.

.05 If it has not already been done, the taxpayer may submit a statement explaining the taxpayer's position on the issues and citing precedents that the taxpayer believes will bear on the case. This statement will be forwarded to the National Office with the request for technical advice. If the taxpayer's statement is received after the request for technical advice has been forwarded to the National Office, it will be forwarded there to be associated with the request for technical advice. The taxpayer is encouraged to comment on any legislation, tax treaties, regulations, revenue rulings, revenue procedures, or court decisions contrary to the taxpayer's position.

.06 At the time the taxpayer is told that the matter is being referred to the National Office, the taxpayer will also be told about the right to a conference in the National Office if an adverse decision is indicated and will be asked to say whether such a conference is desired.

.07 In connection with requests for technical advice, the taxpayer also has the same 10 days as in sections 5.03 and 5.04 to submit the statement described in section 5.09 of proposed deletions under section 6110(c) of the Code. If the taxpayer does not submit the statement, the District Director or the Chief, Appeals Office, will tell the taxpayer that such a statement is required. If the District Director or the Chief, Appeals Office, does not receive that statement within 10 days after such notification, the District Director or the Chief, Appeals Office, may decline to submit the request for technical advice. If the District Director or the Chief, Appeals Office, decides to request technical advice in a case in which the taxpayer has not submitted the statement of proposed deletions, the National Office will make those deletions that the Commissioner determines are required by section 6110(c).

.08 The requirements for submitting statements and other materialfor proposed deletions in technical advice memoranda before public inspection is allowed do not apply to requests for any documents to which section 6104 of the Code applies.

.09 To help the National Office make the deletions required by section 6110(c) of the Code in technical advice memoranda to be made open to public inspection under section 6110(a), a deletions statement must accompany requests. The statement must either state that no information other than names, addresses, and identifying numbers need be deleted, or if more information is proposed to be deleted, the statement must indicate the deletions proposed by the taxpayer. If the latter alternative is chosen, the statement must be made in a separate document, and it must be accompanied by a copy of all statements of facts and supporting documents that are submitted to the National Office under sections 5.03 and 5.04. The material that the taxpayer wants deleted must be shown in brackets. The statement of proposed deletions must show the statutory basis, under section 6110(c), for each proposed deletion. The statement of proposed deletions must not appear or be referred to anywhere in the request for technical advice. If the taxpayer decides to request additional deletions under section 6110(c) before the National Office replies to the request for technical advice, the taxpayer may submit additional statements. The procedures in this paragraph also apply to additional information submitted during consideration of the technical advice request.

.10 The provisions of this section (about referring issues upon the taxpayer's request, telling the taxpayer about the referral of issues, giving the taxpayer a copy of the arguments submitted by the District Director or Chief, Appeals Office, in support of its position on the issue or issues, submitting proposed deletions, and granting conferences in the National Office) do not apply to technical advice memoranda, described in section 6110(g)(5)(A) of the Code, on cases involving criminal or civil fraud investigations and jeopardy or termination assessments. However, in these cases the taxpayer may provide the statement of proposed deletions to the National Office after all proceedings in the investigations or assessments are complete but before the Commissioner mails the notice, under section 6110(f)(1), of intention to disclose the technical advice memorandum.

.11 See Rev. Proc. 79-63, 1979-2 C.B. 578, which concerns applications for extension of time for making an election or application for relief pursuant to section 1.9100-1 of the Income Tax Regulations. If a taxpayer requests an extension of time under section 1.9100-1 during an examination or when being considered by an Appeals Office, the procedures of Rev. Proc. 88-2 are applicable, except for section 6. The examination officer or Appeals Officer is not authorized to deny consideration of a request for technical advice that involves section 1.9100-1 relief. All such requests must be referred to the National Office. See section 4.03 of Rev. Proc. 79-63.

.12 Form 4463, Request for Technical Advice, should be used for transmitting requests for technical advice to the National Office.

.13 Any authorized representative, as described in section 8.10 of Rev. Proc. 88-1, whether or not enrolled to practice, must comply with the conference and practice requirements of the Statement of Procedural Rules (26 CFR 601). Form 2848, Power of Attorney, and Form 2848-D, Authorization and Declaration, may be used with regard to requests for technical advice under this revenue procedure.

SEC. 6. APPEAL BY TAXPAYERS OF DISTRICT OR APPEALS OFFICE DETERMINATION NOT TO SEEK TECHNICAL ADVICE

.01 If the examining officer or Appeals Officer thinks that a taxpayer's request for referral of an issue to the National Office for technical advice does not warrant referral, the examining officer or Appeals Officer will tell the taxpayer.

.02 The taxpayer may appeal the decision of the examining officer or the Appeals Officer not to request technical advice by submitting to that official, within 10 calendar days after being told of the decision, a statement of the facts, law, and arguments on the issue, and the reasons why the taxpayer believes the matter should be referred to the National Office for technical advice. The tax payer must justify in writing a request for an extension of time beyond the 10 calendar days. The justification must be approved by the Chief, Examination Division, or the Chief, Appeals Office.

.03 The examining officer or the Appeals Officer submits the taxpayer's statement through channels to the Chief, Examination Division, or the Chief, Appeals Office, along with the examining officer's or the Appeals Officer's statement of why the issue should not be referred to the National Office. The Chief determines, on the basis of the statement, whether technical advice will be requested. If the Chief determines that technical advice is not warranted and proposes to deny the request, the taxpayer is told in writing about the determination. In the letter to the taxpayer, the Chief states the reasons for the proposed denial (except in unusual situations when doing so would be prejudicial to the best interests of the Government). The taxpayer has 10 calendar days after receiving the letter to notify the Chief of agreement or disagreement with the proposed denial. The taxpayer may not appeal the decision of the Chief, Examination Division, or the Chief, Appeals Office, not to request technical advice from the National Office. However, if the taxpayer does not agree with the proposed denial, all data on the issue for which technical advice has been sought, including the taxpayer's written request and statements, will be submitted to the Assistant Commissioner (Examination) or the Director, Appeals Division, for review. If the Assistant Commissioner (Examination) or the Director, Appeals Division, thinks the circumstances warrant it, he or she may consult the Associate Chief Counsel (Technical and International) or his or her representatives. After this review, the District Office or the Appeals Office is notified whether the proposed denial is approved or disapproved, and, in turn, the District Office or the Appeals Office will notify the taxpayer.

.04 While the matter is being reviewed, the District Office or the Appeals Office suspends action on the issue (except when the delay would prejudice the Government's interest) until it is notified that the proposed denial is approved or disapproved. This notification is made within 45 calendar days after receipt of the data. The review is solely on the basis of the written record and no conference is held on the matter.

SEC. 7. WITHDRAWAL OF REQUESTS

.01 Only a District Director or Chief, Appeals Office may withdraw a request for technical advice, even a request initiated by the taxpayer. The withdrawal request may be made at any time before the responding transmittal memorandum is signed. The District Director or Chief, Appeals Office, must notify the taxpayer in writing of an intent to withdraw the request for technical advice except (1) when the period of limitation on assessment is about to expire and the taxpayer has declined to sign a consent to extend the period, or (2) when such notification would be prejudicial to the best interests of the Government. If the taxpayer does not agree that the request for technical advice should be withdrawn, the procedure in section 6 of this revenue procedure must be followed.

.02 When a request for technical advice is withdrawn, the National Office may send its views to the District Director or the Chief, Appeals Office, when acknowledging the withdrawal request. In an Appeals case, acknowledgment of the withdrawal request should be sent to the appropriate Appeals Office, through the Director, Appeals Division, CC:AP:PT. In appropriate cases, the subject matter may be published as a revenue ruling or as a revenue procedure.

SEC. 8. CONFERENCES IN THE NATIONAL OFFICE

.01 If after an analysis of the technical advice request it appears that advice adverse to the taxpayer will be given, and if a conference has been requested, the taxpayer will be told, by telephone if possible, the time and place of the conference. The conference must be held within 21 calendar days after such contact has been made. If conferences are being arranged for more than one request for technical advice for the same taxpayer, they will be scheduled to cause the least inconvenience to the taxpayer. An extension of the 21-day period will be granted only if the taxpayer justifies it in writing and the Associate Director or Deputy Associate Director having jurisdiction over the Technical Branch to which the case is assigned approves it. Because the purpose of these procedures is to facilitate the technical advice process, requests for extensions should be justified by compelling facts and circumstances. The request for extension should be submitted before the end of the 21-day period. If unusual circumstances near the end of the 21-day period make a written request impractical, within the 21-day period the National Office should be told orally about the problem and of the forthcoming written request for extension. These requests must be promptly submitted. The taxpayer or taxpayer's representative will be told promptly and later in writing of the approval or denial of the requested extension. There is no right to appeal the denial of an extension request. If it is not advised of problems with meeting the 21-day period, or if the request is not sent promptly after the National Office is notified of problems with meeting the 21-day period, the Service will process the case on the basis of the existing record.

.02 A taxpayer is entitled by right to only one conference in the National Office unless one of the circumstances discussed in this section exists. This conference is normally held at the Branch level in the appropriate division (Individual Tax Division, Corporation Tax Division, or Employee Benefits and Exempt Organizations Division) of the Office of the Associate Chief Counsel (Technical and International). It is attended by a person who has authority to sign the transmittal memorandum discussed in section 9.07 on behalf of the Branch Chief. When more than one branch has taken an adverse position on an issue within its jurisdiction presented in a request for technical advice, or when the position ultimately adopted by one Branch will affect another Branch's determination, a representative from each Branch with authority to sign for the Branch Chief will attend the conference. In appropriate cases, the examining officer or the Appeals Officer may also attend the conference to clarify the facts in the case. If more than one subject is discussed at the conference, the discussion constitutes a conference for each subject. To promote a free and open discussion of the issues, the conference usually is held after the Branch has an opportunity to study the case. However, the taxpayer may request that the conference of right be held at a stage earlier in the consideration of the case than the Service would ordinarily designate. The taxpayer has no right to appeal the action of a Branch to a Division Director or to any other official of the Service.

.03 In order to issue technical advice memoranda in a more efficient manner, the Branch representatives may offer the taxpayer an option of delaying the conference in order to submit a brief requesting section 7805(b) relief, discussed in section 12 of this revenue procedure, in the event of a final adverse determination by the Service. In such cases, a conference on the tentatively adverse position and the section 7805(b) relief request will be scheduled within 10 days of receipt of the taxpayer's section 7805(b) request.

.04 Because conference procedures are informal, no tape, stenographic, or other verbatim recording of a conference is made.

.05 The senior Service representative at the conference ensures that the taxpayer has full opportunity to present views on all the issues in question. The Service representatives explain the Service's tentative decision on the substantive issues and the reasons for it. If prospective application under section 7805(b) of the Code is advanced by the taxpayer, the Service representative will discuss the tentative recommendation concerning the request for relief and the reason for the tentative recommendation. No commitment will be made as to the conclusion that the Service will finally adopt.

.06 An invitation to an additional conference is made if, after the conference of right, an adverse holding is proposed either (1) on a new issue or (2) on the same issue but on grounds different from those discussed at the first conference. When a proposed holding is reversed at a higher level with a result less favorable to the taxpayer, the taxpayer has no right to another conference if the grounds or arguments on which the reversal is based were discussed at the conference of right. The limitation on the number of conferences to which a taxpayer is entitled does not prevent inviting a taxpayer to attend further conferences when National Office personnel think they are necessary. These additional conferences are held only at the invitation of the National Office.

.07 The taxpayer is responsible for furnishing in writing to the National Office within 21 calendar days after the conference any additional data, lines of reasoning, precedents, etc., that the taxpayer proposed and that were discussed at the conference but not previously or adequately presented in writing. A copy of the additional material submitted by the taxpayer must be sent by the taxpayer to the District Director or the Chief, Appeals Office, for comment. If the additional information is not received within 21 days, the technical advice memorandum will be issued on the basis of the existing record. An extension of the 21-day period may be granted only if the taxpayer justifies it in writing and the Associate Director or Deputy Associate Director having jurisdiction over the Branch to which the case is assigned approves it. Procedures for requesting an extension of the 21-day period and notifying the taxpayer or the taxpayer's representative of the Service's decision are the same as those in section 8.01. Any additional material should be submitted in duplicate to the National Office. If the additional information would have a significant impact on the facts in the request for technical advice, the National Office sends a copy to the District Director or the Chief, Appeals Office, for comment on the facts contained in the additional information submitted. The District Director or the Chief, Appeals Office, gives the matter prompt attention.

.08 A taxpayer may get information on the status of the request for technical advice by contacting the District or Appeals Office that requested the technical advice.

.09 A District Director or a Chief, Appeals Office, may get current information on the status of the request for technical advice by calling the person whose name and telephone number are shown on the acknowledgement of receipt of the request for technical advice.

SEC. 9. PREPARATION OF TECHNICAL ADVICE MEMORANDUM BY THE NATIONAL OFFICE

.01 Requests for technical advice generally are given priority and processed expeditiously. As soon as the request for technical advice is assigned, the technical employee analyzes the file to see whether it meets all requirements of section 5. If it does not comply with the requirements of section 5.09 relating to the statement of proposed deletions, the National Office makes the deletions from the technical advice memorandum that the Commissioner determines are required by section 6110(c) of the Code.

.02 Usually, within 21 calendar days after the Branch Office receives the request for technical advice, a representative of the Branch telephones the District or Appeals Office to discuss the procedural and substantive issues in the request that come within the Branch's jurisdiction. The Branch representative informs the District or Appeals Office:

(a) that the case is being returned because substantial additional information is required to resolve an issue, because significant unresolved factual variances exist between the statement of facts submitted by the District or Appeals Office and the taxpayer, or because major procedural problems cannot be resolved by phone (A request for technical advice will not be returned or reply delayed merely because additional information not essential to the preliminary assessment of the case is needed.); or

(b) that the case is not being returned but more information is needed or minor procedural deficiencies exist; or

(c) what the Branch representative's tentative conclusion is and the estimated date that the technical advice memorandum will be mailed; or

(d) that a tentative conclusion has not been reached because of the complexity of the issue and the estimated date the tentative conclusion will be made.

.03 Within 21 calendar days after the Branch receives the additional information requested in section 9.02(b), the Branch representative telephones the District or Appeals Office to discuss the procedural and substantive issues in the request that come within the jurisdiction of the Branch. The representative indicates either (1) the tentative conclusion and the estimated date the technical advice memorandum will be mailed, or (2) the fact that a tentative conclusion has not been reached because of the complexity of the issue and the estimated date the tentative conclusion will be made.

.04 Because the Branch representative's tentative conclusion may change during the preparation and review of the technical advice memorandum, it is not, under any circumstances, considered final. The District or Appeals Office may not tell the taxpayer what the tentative conclusion is.

.05 When the technical advice request concerns matters within the jurisdiction of more than one Branch, a representative of the Branch that received the original technical advice request informs the District or Appeals Office within the initial 21-calendar day period: (1) that the matters within the jurisdiction of another Branch have been referred to the other Branch or office for consideration, and (2) that a representative of the other Branch will contact the District or Appeals Office about the referral of the technical advice request within 21 calendar days after receiving it in accordance with section 9.02.

.06 If during the analysis and development of the case it is determined after discussion with the Branch Chief or reviewer, that additional information essential to the preliminary assessment of the case is needed, a Branch representative will obtain the additional information in the most expeditious manner possible from the taxpayer or the District Director or Chief, Appeals Office. Any additional information requested from the taxpayer by the National Office must be submitted by letter appended by a penalties of perjury statement within 21 calendar days after the request for information is made. A written request for an extension of time to submit additional material must be received by the National Office within the 21-day period, setting forth compelling facts and circumstances justifying the proposed extension. The Branch Chief of the Branch to which the case is assigned will determine whether to grant or deny the request for an extension of the 21-day period. There is no right to appeal the denial of an extension request. If the National Office does not receive the submission within the period of 21 days, plus any extensions granted by the Branch Chief, the National Office will issue the technical advice memorandum based on the existing record.

.07 Any additional information submitted by the taxpayer should be sent to the National Office and a copy sent to either the District Director or the Chief, Appeals Office, for comments on the additional information. If the District Director or Chief, Appeals Office, has comments, they must be furnished promptly to the National Office Rulings Branch.

.08 Generally, before replying to the request for technical advice, the National Office informs the taxpayer orally or in writing of the material likely to appear in the technical advice memorandum that the taxpayer proposed be deleted but that the Service determined should not be deleted. If so informed, the taxpayer may submit within 10 calendar days any further information, arguments, or other material that should be deleted. The Service attempts, if possible, to resolve all disagreements about proposed deletions before the National Office replies to the request for technical advice. However, the taxpayer does not have the right to a conference to resolve any disagreements about material to be deleted from the text of the technical advice memorandum. These matters, however, may be considered at any conference otherwise scheduled for the request.

.09 Replies to requests for technical advice are addressed to the District Director or the Chief, Appeals Office. When a request for technical advice is from Appeals, the response to the appropriate Appeals Office will be routed through the Director, Appeals Division, CC:AP:PT. The replies to technical advice requests are in two parts. Each part identifies the taxpayer by name, address, identification number, and year or years involved. The first part of the reply is a transmittal memorandum. In unusual cases it is a way of giving the District or Appeals Office administrative information or other information that under the nondisclosure statutes or for other reasons, may not be discussed with the taxpayer. The second part (the "technical advice memorandum") contains: (1) a statement of the issues; (2) a statement of the pertinent facts in the issues; (3) a statement of the pertinent law, tax treaties, regulations, revenue rulings and other precedents published in the Bulletin, and court decisions; (4) a discussion of the rationale developed by the National Office; and (5) the conclusions of the National Office. The conclusions give direct answers, whenever possible, to the specific questions of the District or Appeals Office. The discussion of the issues is in enough detail so the District or Appeals officials know the reasoning underlying the conclusion. Accompanying the technical advice memorandum is a notice, under section 6110(f)(1) of the Code, of intention to disclose a technical advice memorandum (including a copy of the version proposed to be open to public inspection and notations of third party communications under section 6110(d)). The District Director or the Chief, Appeals Office, forwards this notice to the taxpayer when the District Director or the Chief, Appeals Office, gives a copy of the technical advice memorandum to the taxpayer according to section 9.08.

.10 A copy of the technical advice memorandum will be given to the taxpayer only after it has been adopted by the District Director or the Chief, Appeals Office. However, in the case of technical advice memoranda described in section 6110(g)(5)(A) of the Code, relating to cases involving criminal or civil fraud investigations and jeopardy or termination assessments, a copy of the technical advice memorandum is not given to the taxpayer until all proceedings in the investigations or assessments are completed.

.11 After receiving the notice under section 6110(f)(1) of the Code of intention to disclose the technical advice memorandum, the taxpayer may protest the disclosure of certain information in it. The taxpayer must submit a written statement within 20 calendar days identifying those deletions not made by the Service that the taxpayer believes should have been made. The taxpayer must also submit a copy of the version of the technical advice memorandum proposed to be open to public inspection with brackets around deletions that are proposed by the taxpayer but that have not been made by the National Office. Generally, the National Office does not consider the deletion of any material that the taxpayer has not proposed be deleted before the National Office reply is sent to the request for technical advice to the District Director or the Chief, Appeals Office. Within 20 days after it receives the taxpayer's response to the notice under section 6110(f)(1), the National Office must mail the taxpayer its final administrative conclusion about the deletions to be made.

SEC. 10. ACTION ON TECHNICAL ADVICE IN DISTRICT AND APPEALS OFFICE

.01 The District Director or the Chief, Appeals Office, must process the taxpayer's case on the basis of the conclusions in the technical advice memorandum unless (1) the District Director or the Chief, Appeals Office, thinks that the conclusions reached by the National Office in a technical advice memorandum should be reconsidered, or (2) the Chief, Appeals Office, in the case of technical advice unfavorable to the taxpayer, decides to settle the issue in the usual manner under existing authority.

.02 The District Director or the Chief Appeals Office, gives the taxpayer (1) a copy of the technical advice memorandum described in section 9.07, and (2) the notice under section 6110(f)(1) of the Code of intention to disclose the technical advice memorandum (including a copy of the version proposed to be open to public inspection and notations of third party communications under section 6110(d)). This requirement does not apply to technical advice memoranda involving civil fraud or criminal investigations; jeopardy or termination assessments, as described in section 5.10; or documents to which section 6104 applies.

.03 In those cases in which the National Office tells the District Director or the Chief, Appeals Office, that a copy of the technical advice memorandum should not be given to the taxpayer, the District Director or the Chief, Appeals Office tells this to the taxpayer if the taxpayer requests a copy.

SEC. 11. EFFECT OF TECHNICAL ADVICE

.01 A taxpayer may not rely on a ruling issued to, or a technical advice memorandum received from the Service by, another taxpayer. Except in rare or unusual circumstances, a holding in a technical advice memorandum that is favorable to the taxpayer is applied retroactively. Moreover, since technical advice, as described in section 4.04 of this revenue procedure, is issued only on closed transactions, a holding that is adverse to the taxpayer is also applied retroactively unless the Associate Chief Counsel (Technical and International) exercises the discretionary authority under section 7805(b) of the Code to limit the retroactive effect of the holding.

.02 A holding that modifies or revokes a holding in a prior technical advice memorandum is applied retroactively, with one exception. If the new holding is less favorable to the taxpayer than the earlier one, it generally is not applied to the period in which the taxpayer relied on the prior holding in situations involving continuing transactions.

.03 If a technical advice memorandum relates to a continuing action or a series of actions, it is ordinarily applied until specifically withdrawn or until the conclusion is modified or revoked by enactment of legislation, ratification of a tax treaty, or issuance of a United States Supreme Court decision, regulations (temporary or final), a revenue ruling, or other statement published in the Internal Revenue Bulletin. Publication of a notice of proposed rulemaking does not affect the application of a technical advice memorandum.

.04 Generally, a technical advice memorandum that revokes or modifies a letter ruling or another technical advice memorandum is not applied retroactively for either the taxpayer to whom or for whom the ruling or memorandum was originally issued or for a taxpayer whose tax liability was directly involved in such ruling or memorandum if: (1) there has been no misstatement or omission of material facts; (2) the facts at the time of the transaction are not materially different from the facts on which the ruling or memorandum was based; (3) there has been no change in the applicable law; (4) in the case of a ruling, it was originally issued on a prospective or proposed transaction; and (5) the taxpayer directly involved in the ruling or memorandum acted in good faith in relying on the ruling or memorandum and the retroactive revocation would be to the taxpayer's detriment. For example, the tax liability of each shareholder is directly involved in a ruling or memorandum on the reorganization of a corporation. However, the tax liability of members of an industry is not directly involved in a ruling or memorandum issued to one of the members, and the holding in a revocation or modification of a ruling or memorandum to one member of an industry may be retroactively applied to other members of the industry. By the same reasoning, a tax practitioner may not obtain the nonretroactive application to one client of a modification or revocation of a ruling or memorandum previously issued to another client. When a ruling to a taxpayer or a memorandum involving a taxpayer is revoked with retroactive effect, the notice to the taxpayer, except in fraud cases, sets forth the grounds on which the revocation is being made and the reasons why the revocation is being applied retroactively.

SEC. 12. PROCEDURES FOR REQUESTING APPLICATION OF SECTION 7805(b) IN THE CASE OF TECHNICAL ADVICE

.01 Pursuant to section 7805(b) of the Code, it is within the discretion of the Commissioner or the Commissioner's delegate to prescribe the extent, if any, to which any ruling (including technical advice) will be applied without retroactive effect.

A taxpayer who has received a technical advice memorandum or with respect to whom a technical advice request is pending may request that the Associate Chief Counsel (Technical and International), the commissioner's delegate, exercise the discretionary authority under section 7805(b) of the Code to limit the retroactive effect of any holding stated in the technical advice memorandum or to limit the retroactive effect of any subsequent modification or revocation of the technical advice memorandum.

.02 When a technical advice memorandum that concerns a continuing transaction is modified or revoked by, for example, a subsequent revenue ruling or final regulations, a request to limit the retroactive effect of the modification or revocation of the technical advice memorandum must be made in the form of a request for a ruling when the request is submitted before the return is examined that contains the transaction that is the subject of the request for ruling. See section 19.02 of Rev. Proc. 88-1, page 557, this Bulletin.

.03 When a taxpayer is informed of the modification or revocation of a technical advice memorandum, ruling letter, or determination letter during the course of an examination of the taxpayer's return by the District Director or during consideration by the Chief, Appeals Office, a request to limit the retroactive application of the modification or revocation of the technical advice memorandum, ruling letter, or determination letter must itself be made in the form of a request for technical advice. See section 5 of this revenue procedure. However, the taxpayer must also submit a statement, which will be forwarded to the National Office with the request for technical advice, that the request for technical advice, that the request for technical advice is being made pursuant to section 7805(b) of the Code. This statement must also set forth the relief sought and an explanation of the reasons and arguments in support of the relief requested, and it must be accompanied by any documents bearing on the request. The explanation in support of the application of section 7805(b) should include a discussion of the five items enumerated in section 11.04 of this revenue procedure as they relate to the taxpayer's particular situation. The taxpayer's request for relief pursuant to section 7805(b) must be forwarded by the District Director or the Chief, Appeals Office to the National Office for consideration.

.04 A request to limit the retroactive effect of a holding in a technical advice memorandum that does not modify or revoke a technical advice memorandum may be made as part of that technical advice request, either intially, or at any time before the technical advice memorandum is issued by the National office. In such a case, the taxpayer must also submit a statement in support of the application of section 7805(b) of the Code, as described in .03 above.

.05 When a request for technical advice concerns only the application of section 7805(b) of the Code, the taxpayer has the right to a conference in the National Office in accordance with the provisions of section 8 of this revenue procedure. If the request for application of section 7805(b) is included in the request for technical advice on the substantive issues or is made before the conference of right on the substantive issues, the section 7805(b) issues will be discussed at the taxpayer's one conference of right. If the request for the application of section 7805(b) is made as part of a pending technical advice request after a conference has been held on the substantive issue, and the Service determines that there is justification for having delayed the request, then the taxpayer will have the right to one conference of right concerning the application of section 7805(b) with the conference limited to discussion of this issue.

SEC. 13. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 87-2 is superseded.

---

26 CFR 601.201: Rulings and determination letters:

Rev. Proc. 88-3

SECTION 1. PURPOSE AND NATURE OF CHANGES

.01 The purpose of this revenue procedure is to update Rev. Proc. 87-3, 1987-1 C.B. 523, as amplified, and modified by subsequent revenue procedures, by providing a revised list of those areas of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Technical and International) relating to non-international issues in which the Internal Revenue Service will not issue advance rulings or determination letters. For a list of areas under the jurisdiction of the Associate Chief Counsel (Technical and International) relating to international issues in which the Service will not issue advance rulings or determination letters, see Rev. Proc. 87-6, 1987-1 C.B. 541. When applicable, the Tax Reform Act of 1986 will be referred to as "TRA 1986."

.02 Changes

1. New section 3.017 amplifies old section 3.017. See Rev. Proc. 87-30, 1987-1 C.B. 774, section 3.05.

2. New section 3.0128 refers to section 453A(a) of the Internal Revenue Code. See Rev. Proc. 87-30, 1987-1 C.B. 774.

3. Old section 3.0130 has been deleted. See Rev. Proc. 87-35, 1987-2 C.B. 456.

4. New section 3.023 modifies old section 3.023. See Rev. Proc. 87-58, 1987-2 C.B. 764.

5. New section 3.026 amplifies old section 3.026.

6. New section 4.0119 clarifies old section 4.0119.

7. New section 5.06 refers to section 105 of the Code. See Rev. Proc. 87-46, 1987-2 C.B. 634.

8. New section 5.14 refers to sections 332 and 337 of the Code. See Rev. Proc. 87-23, 1987-1 C.B. 720.

9. New section 5.38 refers to section 7701 of the Code. See Rev. Proc. 87-37, 1987-2 C.B. 503.

10. New section 5.39 refers to section 7701 of the Code. See Rev. Proc. 87-59, 1987-2 C.B. 764.

SEC. 2. BACKGROUND AND SCOPE OF APPLICATION

.01 Background

Whenever appropriate in the interest of sound tax administration, it is the policy of the Service to answer inquiries of individuals and organizations regarding their status for tax purposes and the tax effects of their acts or transactions, prior to the filing of returns or reports that are required by the revenue laws.

There are, however, certain areas in which, because of the inherently factual nature of the problems involved, or for other reasons, the Service will not issue advance rulings or determination letters. These areas are set forth in three sections of this revenue procedure. Section 3 reflects those areas in which advance rulings and determinations will not be issued. Section 4 sets forth those areas in which they will not ordinarily be issued. "Not ordinarily" connotes that unique and compelling reasons must be demonstrated to justify a ruling or determination letter. Those sections reflect a number of specific questions and problems as well as general areas. Section 5 lists specific areas for which the Service is temporarily not issuing advance rulings and determinations because those matters are under extensive study. See Rev. Proc. 88-1, particularly section 7 captioned "Discretionary Authority to Issue Rulings and Determination Letters" for general instructions and other situations in which the Service will not or ordinarily will not issue rulings or determination letters.

With respect to the items listed, revenue rulings or revenue procedures may be published in the Internal Revenue Bulletin from time to time to provide general guidelines regarding the position of the Service.

Additions or deletions to this revenue procedure as well as restatement of items listed will be made by modification of this revenue procedure. Changes will be published as they occur throughout the year and will be incorporated annually in a new revenue procedure published as the third revenue procedure of the year. These lists should not be considered all-inclusive. Decisions not to rule on individual cases, as contrasted with those that present significant pattern issues, are not reported in this revenue procedure and will not be added to subsequent revisions.

The authority and general procedures of the Technical Function of the National Office of the Internal Revenue Service or the Offices of the District Directors of the Internal Revenue with respect to the issuance of advance rulings and determination letters with respect to Code sections under the jurisdiction of the Associate Chief Counsel (Technical and International) are outlined in Rev. Proc. 88-1, page 557, this Bulletin. For a list of the areas involving international transactions in which the Internal Revenue Service will not or ordinarily will not issue advance rulings or determination letters, see Rev. Proc. 88-6.

.02 Scope of Application

This revenue procedure is not to be considered as precluding the submission of requests for technical advice to the National Office from the Office of a District Director of the Internal Revenue or a Chief, Appeals Office.

SEC. 3. AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT BE ISSUED

.01 Specific questions and problems.

1. Section 79.—Group Term Life Insurance Purchased for Employees.—Whether a group insurance plan for 10 or more employees qualifies as group-term insurance if the amount of insurance is not computed under a formula that would meet the requirements of section 1.79-1(c)(2)(ii) if the group consisted of fewer than 10 employees.

2. Section 83.—Property Transferred in Connection with Performance of Services.—Whether a restriction constitutes a substantial risk of forfeiture if the employee is a controlling shareholder. Also, whether a transfer has occurred if the amount of property involves a nonrecourse obligation.

3. Section 105(h).—Amount Paid to Highly Compensated Individuals under Discriminatory Self-Insurance Medical Expense Reimbursement Plan.—Whether, following a determination that a self-insured medical expense reimbursement plan is discriminatory, that plan had previously made reasonable efforts to comply with tax discrimination rules.

4. Section 117.—Scholarships and Fellowship Grants.—Whether as employer-related scholarship or fellowship grant is excludable from the employee's gross income if there is no intermediary private foundation distributing the grants, as there was in Rev. Proc. 76-47, 1976-2 C.B. 670.

5. Section 119.—Meals or Lodging Furnished for the Convenience of the Employer.—Whether the value of meals or lodging is excludable from gross income by an employee who is a controlling shareholder of the employer.

6. Sections 121 and 1034.—One-Time Exclusion of Gain from Sale of Principal Residence by Individual Who Has Attained Age 55; Rollover of Gain on Sale of Principal Residence.—Whether property qualifies as the taxpayer's principal residence.

7. Section 162.—Trade or Business Expenses.—Whether compensation is reasonable in amount. Also, whether an action is "gross misconduct" within the meaning of section 162(k)(3)(B) (See Rev. Proc. 87-28, section 3.05).

8. Section 163.—Interest.—The income tax consequences of transactions involving a "shared appreciation mortgage" (SAM) loans in which a taxpayer, borrowing money to purchase real property, pays a fixed rate of interest on the mortgage loan below the prevailing market rate and will also pay the lender a percentage of the appreciation in value of the real property upon termination of the mortgage. This applies to all SAM arrangements where the loan proceeds are used for commercial or business activities, or where used to finance a personal residence if the facts are not similar to those described in Rev. Rul. 83-51, 1983-1 C.B. 48. (Also sections 61, 451, 461, 856, 1001, and 7701).

9. Section 170.—Charitable, Etc., Contributions and Gifts.—Whether a charitable lead interest qualifies as a guaranteed annuity interest for purposes of section 170(f)(2)(B) of the Code if that interest may be prepaid before the expiration of the specified term of that interest or before the death of the life or lives used to measure the term of such interest.

10. Section 170.—Charitable, Etc., Contributions and Gifts.—Whether a taxpayer who advances funds to a charitable organization and receives therefor a promissory note may deduct as contributions, in one taxable year or in each of several years, amounts forgiven by the taxpayer in each of several years by endorsement on the note.

11. Section 213(a).—Medical, Dental, Etc., Expenses.—Whether a capital expenditure for an item that is ordinarily used for personal, living, or family purposes, such as a swimming pool, has as its primary purpose the medical care of the taxpayer or the taxpayer's spouse or dependent, or is related directly to such medical care.

12. Section 264(b).—Certain Amounts Paid in Connection with Insurance contracts.—Whether "substantially all" the premiums of a contract of insurance are paid within a period of 4 years from the date on which the contract is purchased. Also, whether an amount deposited is in payment of a "substantial number" of future premiums on such a contract.

13. Section 264(c)(1).—Certain Amounts Paid in Connection with Insurance Contracts.—Whether section 264(c)(1) of the Code applies.

14. Section 269.—Acquisitions Made to Evade or Avoid Income Tax.—Whether an acquisition is within the meaning of section 269 of the Code.

15. Section 274.—Disallowance of Certain Entertainment, Etc., Expenses.—Whether a taxpayer who is traveling away from home on business may, in lieu of substantiating the actual cost of meals, deduct a fixed per-day amount for meal expenses that differs from the amount prescribed in Rev. Proc. 83-71, 1983-2 C.B. 590, or any later revenue procedure that modifies Rev. Proc. 83-71.

16. Section 302.—Distributions in Redemption of Stock.—Whether section 302(b) of the Code applies when the consideration given in redemption by a corporation consists entirely or partly of its notes payable, and the shareholder's stock is held in escrow or as security for payment of the notes with the possibility that the stock may or will be returned to the shareholder in the future, upon the happening of specified defaults by the corporation.

17. Section 302.—Distributions in Redemption of Stock.—Whether section 302(b) of the Code applies when the consideration given in redemption by a corporation in exchange for a shareholder's stock consists entirely or partly of the corporation's promise to pay an amount based on, or contingent on, future earnings of the corporation, when the promise to pay is contingent on working capital be-

ing maintained at a certain level, or any other similar contingency.

18. Section 302.—Distributions in Redemption of Stock.—Whether section 302(b) of the Code applies to a redemption of stock if after the redemption the distributing corporation uses property that is owned by the shareholder from whom the stock is redeemed and the payments by the corporation for the use of the property are dependent upon the corporation's future earnings or are subordinate to the claims of the corporation's general creditors. Payments for the use of property will not be considered to be dependent upon future earnings merely because they are based on a fixed percentage of receipts or sales.

19. Section 302.—Distributions in Redemption of Stock.—Whether the acquisition or disposition of stock described in section 302(c)(2)(B) of the Code has, or did not have, as one of its principal purposes the avoidance of federal income taxes within the meaning of that section, unless the facts and circumstances are materially identical to those set forth in Rev. Rul. 56-556, 1956-2 C.B. 177, Rev. Rul. 56-584, 1956-2 C.B. 179, Rev. Rul. 57-387, 1957-2 C.B. 225, Rev. Rul. 77-293, 1977-2 C.B. 91, Rev. Rul. 79-67, 1979-1 C.B. 128, or Rev. Rul. 85-19, 1985-1 C.B. 94.

20. Sections 302(b)(4) and (e) (pre-TEFRA sections 346(a)(2) and (b)).—Partial Liquidation.—The amount of working capital attributable to a business or portion of a business terminated that may be distributed in partial liquidation.

21. Sections 311 and 336 (pre-TRA 1986).—Taxability of Corporation on Distribution; General Rule.—Upon distribution of property in kind by a corporation to its shareholders, in complete liquidation under section 331 of the Code (when under the facts a sale of the property by the corporation would not qualify under pre-TRA 1986 section 337) and section 346(a) (pre-TEFRA section 346(a)(1)), in partial liquidation under section 302(b)(4) and (e) (pre-TEFRA sections 346(a)(2) and (b)) or in redemption of stock under section 302(a), followed by a sale of the property, whether the sale can be deemed to have been made by the corporation under the doctrine of *Commissioner v. Court Holding Company*, 324 U.S. 331 (1945), 1945 C.B. 58.

22. Section 312.—Effect on Earnings and Profits.—The determination of the amount of earnings and profits of a corporation.

23. Section 368(a)(1)(B).—Definitions Relating to Corporate Reorganizations.—The acceptability of an estimation procedure or the acceptability of a specific sampling procedure to determine the basis of stock acquired by an acquiring corporation in a reorganization described in section 368(a)(1)(B).

24. Section 368(a)(1)(E).—Definitions Relating to Corporate Reorganizations.—Whether a transaction constitutes a corporate recapitalization within the meaning of section 368(a)(1)(E) of the Code (or a transaction that also qualifies under section 1036) except when the recapitalization is an integral part of a larger transaction and it is impossible to determine the tax consequences of the larger transaction without making a determination with regard to the recapitalization.

25. Section 451.—General Rule for Taxable Year of Inclusion.—The tax consequences of a nonqualified unfunded deferred compensation arrangement with respect to a controlling shareholder employee eligible to participate in the arrangement.

26. Sections 451 and 457.—General Rule for Taxable Year of Inclusion; Deferred Compensation Plans with Respect to Service for State and Local Governments.—The tax consequences to unindentified independent contractors in nonqualified unfunded deferred compensation plans. This applies to plans established under section 451 of the Code by employers in the private sector and to eligible state plans under section 457. However, a ruling with respect to a specific independent contractor's participation in such a plan may be issued.

27. Section 453.—Revolving Credit Sales as Installment Sales.—Whether a proposed sampling procedure will be acceptable by the Service for the purpose of determining the portion of revolving credit balances to be treated as installment account balances. See Rev. Proc. 64-4, 1964-1 (Part 1) C.B. 644, and Rev. Proc. 65-5, 1965-1 C.B. 720.

28. Section 453A(a).—Installment Method For Dealers In Personal Property—Whether sales made by a dealer under a deferred payment plan qualify for treatment as sales on the installment plan under section 1.453-2(b)(1) of the Income Tax Regulations.

29. Section 641.—Imposition of Tax.—Whether the period of administration or settlement of an estate is reasonable or unduly prolonged.

30. Section 642(c).—Deduction for Amounts Paid or Permanently Set Aside for a Charitable Purpose.—Allowance of an unlimited deduction for amounts set aside by a trust or estate for charitable purposes when there is a possibility that the corpus of the trust or estate may be invaded.

31. Section 704(e).—Family Partnerships.—Matters relating to the validity of a family partnership when capital is not a material income producing factor.

32. Section 856.—Definition of a Real Estate Investment Trust.—Whether a corporation whose stock is "paired" with or "stapled" to stock of another corporation will qualify as a real estate investment trust under section 856 of the Code if the activities of the corporations are integrated.

33. Section 1221.—Capital Asset Defined.—Whether specialty stock allocated to an investment account by a registered specialist on a national securities exchange is a capital asset.

34. Section 1551.—Disallowance of Surtax Exemption and Accumulated Earnings Credit.—Whether a transfer is within section 1551 of the Code.

35. Section 2031.—Definition of Gross Estate.—Actuarial factors for valuing interests in the prospective gross estate of a living person.

36. Section 2055.—Transfers for Public, Charitable and Religious Uses.—Whether a charitable lead interest qualifies as a guaranteed annuity interest for purposes of section 2055(e)(2)(B) of the Code if that interest may be prepaid before the expiration of the specified term of that interest or before the death of the life or lives used to measure the term of such interest.

37. Section 2512.—Valuation of Gifts.—Actuarial factors for valuing prospective or hypothetical gifts of a donor.

38. Section 2522.—Charitable and Similar Gifts.—Whether a charitable lead interest for purposes of section 2522(c)(2)(B) of the Code if that interest may be prepaid before the expiration of the specified term of that interest or before the death of the life or lives used to measure the term of such interest.

39. Section 7701.—Definitions.—Whether a foreign arrangement that is a participant in a domestic arrangement classified as a partnership for U.S. tax purposes will itself be classified as a partnership.

40. Section 7701.—Definitions.—Whether a foreign limited liability company will be classified as a partnership if the taxpayer requests classification as a partnership and (1) the taxpayer is a corporation and less than 20 percent of the interests in the limited liability company are held by independent parties or (2) the taxpayer is not a corporation and independent parties hold only a nominal interest in the company.

41. Section 7701.—Definitions.—Whether an organization, formed in a state that has a statute corresponding to the Uniform Limited Partnership Act or the Revised Uniform Limited Partnership Act, lacks the corporate characteristic of continuity of life where, in the case of the removal of a general partner, the partnership agreement allows less than a majority in interest of limited partners to elect a new one to continue the partnership.

42. Section 7701.—Definitions.—Whether a limited partnership will be classified as a partnership if the partnership agreement does not provide that, notwithstanding anything to the contrary that may be expressed or implied in the agreement, the interests of all of the general partners, taken together, in each material item of partnership income, gain, loss, deduction, or credit is equal to at least one percent of each such item at all times during the existence of the partnership. In determining the general partners' interests in such items, limited partnership interests owned by the general partners shall not be taken into account.

43. Section 7701.—Definitions.—Whether a limited partnership will be classified as a partnership if the partnership agreement does not expressly provide that, upon the dissolution and termination of the partnership, the general partners will contribute to the partnership an amount equal to: (a) the deficit balances in their capital accounts; or (b) the excess of 1.01 percent of the total capital contributions of the limited partners over the capital previously contributed by the general partners; or (c) the lesser of (a) or (b).

.02 General Areas

1. The results of transactions that lack bona fide business purpose or have as their principal purpose the reduction of federal taxes.

2. A matter upon which a court decision adverse to the government has been handed down and the question of following the decision or litigating further has not yet been resolved.

3. A matter involving the prospective application of the estate tax to the property or the estate of a living person, except as provided in Rev. Proc. 87-58, 1987-2 C.B. 764.

4. A matter involving alternate plans of proposed transactions or involving hypothetical situations.

5. A matter involving the federal tax consequences of any proposed federal, state, local or municipal legislation. The Service may provide general information in response to an inquiry.

6. Whether under Subtitle F (Procedure and Administration) of the Code, reasonable cause, due diligence, good faith, clear and convincing evidence or other similar terms that require a factual determination exist.

7. Whether a proposed transaction would subject the taxpayer to a criminal penalty.

8. A request that does not comply with the provisions of Rev. Proc. 88-1.

9. Whether, under the common law rules applicable in determining the employer-employee relationship, a professional staffing corporation (loan-out corporation) or the subscriber is the employer of individuals if:

(a) the loan-out corporation hires employees of the subscriber and assigns the employees back to the subscriber or;

(b) the loan-out corporation assigns individuals to subscribers for more than a temporary period (1 year or longer).

SEC. 4. AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT ORDINARILY BE ISSUED

.01 Specific questions and problems.

1. Sections 38, 39, 46, and 48.—Investment Tax Credit.—Application of these sections where the formal ownership of property is in a party other than the taxpayer, except when title is held merely as security.

2. Section 61.—Gross Income Defined.—Determination as to who is the true owner of property in cases involving the sale of securities, or participation interests therein, where the purchaser has the contractual right to cause the security or participation interest therein, to be purchased by either the seller or a third party.

3. Sections 61 and 163.—Gross Income Defined; Interest.—Determinations as to who is the true owner of property or the true borrower of money in cases in which the formal ownership of the property or liability for the indebtedness is in another party.

4. Section 103.—Interest on Certain Governmental Obligations.—Whether the interest on state and local governmental obligations will be excludable from gross income under section 103(a) of the Internal Revenue Code if the proceeds of issues of obligations (other than advance refunding issues) are placed in escrow or otherwise not expended for a governmental purpose for an extended period of time even though the proceeds are invested at a yield that will not exceed the yield on the governmental obligations prior to their expenditure.

5. Section 103.—Interest on Certain Governmental Obligations.—Whether municipal bonds will meet the "security interest test" under section 103(b)(2)(B) of the Code and section 1.103-7(b)(4) of the regulations because an underlying arrangement is inferred, as illustrated in Rev. Rul. 80-251, 1980-2 C.B. 40, and Rev. Rul. 80-339, 1980-2 C.B. 42, when payments not pledged as security for the bonds are received in respect of the bond-financed property used in the trade or business of nonexempt persons in an amount

equal to more than 25 percent of the principal or interest payments on the bonds.

6. Section 103.—Interest on Certain Governmental Obligations.—Whether an issue of industrial development bonds is exempt under section 103(b) of the Code when 10 percent or more of the proceeds of the issue (minus "neutral costs," as described in Rev. Rul. 80-171, 1980-2 C.B. 44) are used to finance a facility in what an owner (or a related person) or a lessee (or a related person), who was a user of the facility at any time before the bonds were issued, will be a user of the facility after the bonds are issued.

7. Section 103.—Interest on Certain Governmental Obligations.—Whether amounts received as proceeds from the sale of municipal bond financed property and pledged to the payment of debt service or pledged as collateral for the municipal bond issue are sinking fund proceeds within the meaning of section 1.103-13(g) of the Income Tax Regulations or replaced proceeds described in section 103(c)(2)(B) of the Internal Revenue Code.

8. Section 162.—Trade or Business Expenses.—Whether the requisite risk shifting and risk distribution necessary to constitute insurance are present for purposes of determining the deductibility under section 162 of amounts paid (premiums) by a taxpayer for insurance, unless the facts of the transaction are within the scope of Rev. Rul. 77-316, 1977-2 C.B. 53, or Rev. Rul. 78-338, 1978-2 C.B. 107.

9. Section 167.—Depreciation.

(a) Useful lives of assets.

(b) Depreciation rates.

(c) Salvage value of assets.

10. Sections 167 and 168.—Depreciation; Accelerated Cost Recovery System.—Application of these sections where the formal ownership of property is in a party other than the taxpayer, except when title is held merely as security.

11. Section 170(c).—Charitable, etc., Contributions and Gifts.—Whether a taxpayer who transfers property to a charitable organization and thereafter leases back all or a portion of the transferred property, may deduct the fair market value of the property transferred and leased back as a charitable contribution.

12. Section 302.—Distribution in Redemption of Stock.—The tax effect of the redemption of stock for notes, when the payments on the notes are to be made over a period in excess of 15 years from the date of issuance of such notes.

13. Sections 302(b)(4) and (e) (pre-TEFRA section 346(a)(2)).—Partial Liquidation.—Whether a distribution will qualify as a distribution in partial liquidation under section 302(b)(4) and (e)(1)(A) (pre-TEFRA section 346(a)(2)) of the Code, unless it results in a 20 percent or greater reduction in (1) gross revenue, (2) net fair market value of assets, and (3) employees.

14. Sections 302(b)(4) and (e) (pre-TEFRA sections 346(a)(2) and (b)), 331, 332, pre-TRA 1986 section 333 and section 346(a) (pre-TEFRA section 346(a)(1)).—Effects on Recipients of Distributions in Corporate Liquidations.—The tax effect of the liquidation of a corporation preceded or followed by the reincorporation of all or a part of the business and assets when more than a nominal amount of the stock (that is, more than 20 percent in value) of both the liquidating corporation and the transferee corporation is owned by the same shareholders; or when a liquidation is followed by the sales of the corporate assets by the shareholders to another corporation in which such shareholders own more than a nominal amount of the stock (that is, more than 20 percent in value).

15. Section 306.—Disposition of Certain Stock.—Whether the distribution or disposition or redemption of "section 306 stock" in a closely held corporation is in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes within the meaning of section 306(b)(4) of the Code.

16. Sections 331 and 346(a).—Gain or Loss to Shareholders in Corporate Liquidations.—The tax effect of the liquidation of a corporation by a series of distributions, when the distributions in liquidation are to be made over a period in excess of 3 years from the adoption of the plan of liquidation.

17. Section 336 (pre-TRA 1986 section 337).—Gain or Loss: Certain Liquidations.—The application of this section to a corporation upon the sale of property, in connection with its liquidation, to another corporation, when more than a nominal amount of the stock (that is, more than 20 percent in value) of both the selling corporation and the purchasing corporation is owned by the same persons.

18. Section 341.—Collapsible Corporations.—Whether a corporation will be considered to be a "collapsible corporation," that is, whether it was "formed or availed of" with the view of certain tax consequences. However, ruling requests will be considered on this matter when the enterprise (1) has been in existence for at least 20 years or has clearly demonstrated that it has realized two-thirds of the taxable income to be derived from the manufacturing, constructing, producing, or purchasing of property as stated in section 341(b)(1)(A) of the Code and as described in Rev. Rul. 72-48, 1972-1 C.B. 102; (2) has had an aggregate change in the shareholders' interests of not more than 10 percent during that period (except for transfers among family members, as defined in section 267(c)(4), or redemptions of stock to pay death taxes pursuant to section 303); and (3) has conducted substantially the same trade or business during that period. The period referred to in (2) and (3) above is the lesser of 20 years of corporate existence or the period in which the enterprise has realized two-thirds of the taxable income from activities specified in section 341(b)(1)(A).

19. Section 351.—Transfers to Controlled Corporation.—The tax effect of the transfer when part of the consideration received by the transferors consists of an instrument that is a bond, debenture, or any other evidence of indebtedness of the transferee and either (1) the terms of the instrument permit, at the option of the issuer or holder, the payment of all or part of the principal on the instrument in less than 10 years from its issuance, or (2) a determination as to whether the "indebtedness" is properly classified as debt or equity is required in order to establish that the requirements of section 351 are met.

20. Section 355.—Distribution of Stock and Securities of a Controlled Corporation.—Whether the active

business requirement of section 355(b) of the Code is met when, within the 5-year period described in section 355(b)(2)(B), a distributing corporation acquired control of a controlled corporation as a result of the distributing corporation transferring cash or other liquid or inactive assets to the controlled corporation in a transaction in which gain or loss was not recognized as a result of the transfer meeting the requirements of section 351(a) or 368(a)(1)(D).

21. Section 816.—Definition of Life Insurance Company.—Whether the requisite risk shifting and risk distribution necessary to constitute insurance are present for purposes of determining if a company is an "insurance company" under section 1.801-3(a) of the regulations, unless the facts of the transaction are within the scope of Rev. Rul. 77-316, 1977-2 C.B. 53, or Rev. Rul. 78-338, 1978-2 C.B. 107.

22. Section 7701.—Definitions.—Whether what is generally known as a foreign corporation will be classified as a partnership for U.S. tax purposes if the taxpayer requests classification as a partnership.

23. Section 7701.—Definitions.—Whether a foreign partnership will be classified as an association for U.S. tax purposes if the taxpayer requests classification as an association.

.02 General areas.

1. Any matter in which the determination requested is primarily one of fact, e.g., market value of property, or whether an interest in a corporation is to be treated as stock or indebtedness.

2. The tax effect of any transaction to be consummated at some indefinite future time.

3. Any matter dealing with the question of whether property is held primarily for sale to customers in the ordinary course of trade or business.

4. The tax effect of a transaction if any part of the transaction is involved in litigation among the parties affected by the transaction, except for transactions involving bankruptcy reorganizations.

SEC. 5. AREA UNDER EXTENSIVE STUDY IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT BE ISSUED UNTIL THE SERVICE RESOLVES THE ISSUE THROUGH PUBLICATION OF A REVENUE RULING, REVENUE PROCEDURE, REGULATIONS OR OTHERWISE

.01 Section 61.—Gross Income Defined.—Whether amounts voluntarily deferred by a taxpayer under a deferred compensation plan maintained by an organization described in section 501 of the Code are currently includible in the taxpayer's gross income.

.02 Sections 61 and 162.—Gross Income Defined; Trade or Business Expenses.—The tax consequences with respect to a salary reduction arrangement under which an employee receives and returns salary amounts to the employer. (Also sections 3121, 3306 and 3401).

.03 Section 79.—Group-Term Life Insurance Purchased for Employees.—Whether life insurance provided for employers under a "retired lives reserve" plan will be considered group-term insurance (also sections 61, 72, 83, 101, 162, 264, and 641).

.04 Section 101.—Certain Death Benefits.—Whether proceeds of "self-insured" life and survivor benefit plans established through a trust qualified under section 501(c)(9) of the Code are excludable from the beneficiary's gross income as amounts paid by reason of the death of the insured under section 101(a).

.05 Section 103.—Interest on Certain Governmental Obligations.—With respect to requests made pursuant to Rev. Proc. 79-12, 1979-1 C.B. 492, whether municipal bonds will meet the "trade or business test" and the "security interest test" under sections 103(b)(2)(A) and (B) of the Code and section 1.103-7(b)(5) of the regulations when the proceeds are used to finance facilities such as electric energy, gas or water facilities and, pursuant to a contract to take, or to take or pay for, a nonexempt person purchases 75 percent or more of the actual output of the facility but less than 25 percent of the subparagraph (5) output of the facility as defined in section 1.103-7(b)(5)(ii)(b) of the regulations.

.06 Section 105.—Amounts Received Under Accident and Health Plans.—Whether a medical reimbursement plan, funded by employer contributions, containing a provision allowing unused amounts to be carried over and accumulated in an employee's account qualifies as an accident and health plan under section 105 of the Code.

.07 Section 162.—Trade or Business Expenses.—Whether payments paid or accrued by a corporation to an exempt organization as described in sections 501(c)(7), (c)(9), (c)(17), or (c)(20) of the Internal Revenue Code, are deductible under section 162.

.08 Sections 162 and 262.—Commuting Expenses.—Whether expenses are nondeductible commuting expenses.

.09 Section 168(f)(8).—Special Rule for Leases.—The tax consequences in certain areas specifically reserved in the Temporary Income Tax Regulations under the Economic Recovery Act of 1981, relating to special rules for leases. The areas specifically reserved are: section 5c.168(f)(8)-8(b)(9) on retirements and casualties; section 5c.168(f)(8)-9 on the transfer of investment tax credit by section 168(f)(8) leases; section 5c.168(f)(8)-10 on leases between related parties; and section 5c.168(f)(8)-11 on consolidated returns.

.10 Section 216.—Deduction of Taxes, Interest, and Business Depreciation by Cooperative Housing Corporation Tenant Stockholder.—If a cooperative housing corporation, as defined in section 216(b)(1) of the Code, transfers an interest in real property to a corporation (not a cooperative housing corporation), in exchange for stock or securities of the transferee corporation, which engages in commercial activity with respect to the real property interest transferred, whether (1) the income of the transferee corporation derived from the commercial activity, and (2) any cash and property attributable to the real property interest transferred that may be distributed by the transferee corporation to the cooperative housing corporation, will be considered as gross income of the cooperative housing corporation for the purpose of determining whether 80 percent or more of the gross income of the cooperative housing cooperation is derived from tenant-stockholders within the meaning of section 216(b)(1)(D).

.11 Sections 302(b)(4) and (c) (also Pre-TEFRA section 346(a)(2) and (b)).—Partial Liquidation.—Whether the absence of an actual redemption of stock is a meaningless gesture within the meaning of Rev. Rul. 79-257, 1979-2 C.B. 136, as amplified by Rev. Rul. 81-3, 1981-1 C.B. 125, when:

(i) The corporation has outstanding more than one class of stock and there are priorities as to dividend or liquidating distributions or any other differences in stock rights, or

(ii) Either under the terms of the stock or as established contractually, there are outstanding any rights affecting the corporation's stock, such as, but not limited to, warrants, options, convertible securities, shareholder agreements, or rights of first refusal.

.12 Section 306(b)(4).—Transactions Not in Avoidance.—Whether section 306(b)(4) of the Code applies to the distribution and disposition or redemption of "section 306 stock" that is subject to mandatory redemption.

.13 Section 331, pre-TRA 1986 section 337, and sections 453 and 1239.—The Tax Effects of Installment Sales of Property Between Entities with Common Ownership.—The tax effects of a transaction in which there is a transfer of property by a corporation to a partnership or other non-corporation entity (or the transfer of stock to such entity followed by a liquidation of the corporation) when more than a nominal amount of the stock of such corporation and the capital or beneficial interests in the purchasing entity (that is, more than 20 percent in value) is owned by the same persons, and the consideration to be received by the selling corporation or the selling shareholders includes an installment obligation of the purchasing entity.

.14 Sections 332 and 337.—Nonrecognition for Property Distributed to Parent in Complete Liquidation of Subsidiary.—Whether section 1.1502-34 of the Income Tax Regulations is applicable in determining status as an 80-percent distributee as referred to in section 337(c).

.15 Section 334(b)(2)(pre-TEFRA).—Liquidation of Subsidiary.—Whether an acquiring corporation may treat the life insurance reserves received in the liquidation as unsecured liabilities assumed.

.16 Section 336 (pre-TEFRA).—Distribution of Property in Liquidation.—Whether the liquidation of a life insurance subsidiary is a termination pursuant to section 815(d)(2) as in effect before the enactment of the Tax Reform Act of 1984.

.17 Section 338 (pre-TEFRA section 334(b)(2)).—Certain Stock Purchases Treated as Asset Acquisitions.—The tax consequences, under subchapter L, from the stock purchase and the deemed purchase of the assets of a life insurance subsidiary.

.18 Section 351.—Transfer to Corporation Controlled by Transferor.—Whether section 351 applies to the transfer of widely held developed or undeveloped real property or interests therein; widely held oil and gas properties or interests therein; or any similarly held properties or interests to a corporation in exchange for shares of stock of such corporation when (i) the transfer is the result of solicitation by promoters, brokers, or investment houses, or (ii) the transferee corporation's stock is issued in a form designed to render it readily tradable.

.19 Section 351.—Transfer to Corporation Controlled by Transferor.—Whether section 351 of the Code applies to the transfer of an interest in real property by a cooperative housing corporation (as defined in section 216(b)(1)) to a corporation in exchange for stock or securities of the transferee corporation which engages in commercial activity with respect to the real property interest transferred.

.20 Section 368.—Definitions Relating to Corporate Reorganizations.—Whether a transaction qualifies under either section 368(a)(1)(B) or section 351(a) of the Code by reason of Rev. Rul. 67-448, 1967-2 C.B. 144, when the same transaction is structured under sections 368(a)(1)(A) and 368(a)(2)(E) (as a reverse triangular merger) and fails to qualify for an advance ruling under those sections merely because the "substantially all" requirement set forth in section 3.01 of Rev. Proc. 77-37, 1977-2 C.B. 568, as amplified by Rev. Proc. 86-42, 1986-2 C.B. 722, is not met.

.21 Section 422A.—Incentive Stock Options.—Whether Holding (1) of Rev. Rul. 80-244, 1980-2 C.B. 234, relating to section 1036, applies to incentive stock options.

.22 Section 565.—Whether the consent dividend procedure under section 565 applies to corporations other than those corporations to which sections 535, 545, 556, 852, and 857 are applicable.

.23 Section 671.—Trust Income Deductions, and Credits Attributable to Grantor and Others as Substantial Owners.—Whether the grantor will be considered the owner of any portion of a trust when (1) the trust corpus consists or will consist substantially of insurance policies on the life of the grantor or the grantor's spouse, (2) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (3) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, and (4) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under sections 673 to 677.

.24 Section 704(e).—Family Partnerships.—Any matter relating to a family partnership in which, on formation of the partnership or other specified date, there is a special allocation of an item of income, gain, loss deduction or credit for the purpose of fixing or freezing the value of a partner's partnership interest.

.25 Section 721.—Nonrecognition of Gain or Loss on Contribution.—Whether section 721 applies to the contribution of widely held developed or undeveloped real property or interests therein; widely held oil and gas properties or interest therein; or any similarly held properties or interests to a partnership in exchange for an interest in the partnership when (i) the contribution is the result of solicitation by promoters, brokers, or investment houses, or (ii) the interest in the transferee partnership is issued in a form designed to render it readily tradeable.

.26 Section 801(b).—Life Insurance Company Taxable Income Defined.—Whether the liquidation of a life insurance subsidiary pursuant to either section 334(b)(2) (pre-TEFRA) or section 338 (added by TEFRA) is a termination under section 815(d)(2) (as in effect before the enactment of the Tax Reform Act of 1984) causing a distribution from the subsidiary's policyholders surplus account.

.27 Section 805(a)(8).—Other Deductions.—Whether a portion of the purchase price of the stock of the life insurance subsidiary is properly allocable to insurance in force.

.28 Section 811(b)(34).—Amortization of Premium and Accrual of Discount-Exception.—Whether the difference between the face value of bonds held by a life insurance subsidiary liquidating under section 334(b)(2) (pre-TEFRA) or section 338 (added by TEFRA) and the amount allocable to such bonds pursuant to the liquidation is market discount and need not be accrued.

.29 Section 815(d)(2) as in effect before the enactment of the Tax Reform Act of 1984—Termination as Life Insurance Company.—Whether the liquidation of a life insurance subsidiary pursuant to section 334(b)(2) (pre-TEFRA) or section 338 (added by TEFRA) is a termination requiring the application of section 801(c) or section 802(b)(3) as in effect before the enactment of the Tax Reform Act of 1984.

.30 Section 816(b).—Life Insurance Reserves Defined.—Whether the life insurance reserves acquired in the liquidation of a life insurance subsidiary qualify as unsecured liabilities assumed by the acquiring corporation for purposes of section 334(b)(2) (pre- TEFRA) and section 338 (added by TEFRA).

.31 Section 818(b).—Treatment of Capital Gains and Losses, etc.—Whether the purchase of the stock of a life insurance subsidiary and its subsequent liquidation under section 334(b)(2) (pre-TEFRA) or section 338 (added by TEFRA) is, in fact, a purchase of the subsidiary's insurance contracts.

.32 Section 1502.—Regulations.—Whether a parent cooperative housing corporation (as defined in section 216(b)(1)) will be permitted to file a consolidated income tax return with its transferee subsidiary if the transferee engages in commercial activity with respect to the real property interest transferred to it by the cooperative housing corporation.

.33 Section 2503.—Taxable Gifts.—Whether the transfer of property to a trust will be a gift of a present interest in property when (1) the trust corpus consists or will consist substantially of insurance policies on the life of the grantor or the grantor's spouse, (2) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies or insurance on the life of the grantor of the grantor's spouse, (3) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, (4) the trust beneficiaries have the power to withdraw, on demand, any additional transfers made to the trust, and (5) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under sections 673 to 677.

.34 Section 2514.—Powers of Appointment.—If the beneficiaries of a trust permit a power of withdrawal to lapse, whether section 2514(e) of the Code will be applicable to each beneficiary in regard to the power when (1) the trust corpus consists or will consist substantially of insurance policies on the life of the grantor or the grantor's spouse, (2) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (3) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, (4) the trust beneficiaries have the power to withdraw, on demand, any additional transfers made to the trust, and (5) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under sections 673 to 677.

.35 Sections 3121, 3306, and 3401.—Employment Taxes.—Who is the employer of an "employee-owner" as defined in section 269A of the Code.

.36 Section 7701.—Definitions.—The classification of arrangements formed as trusts under local law, in which the trust borrows money to purchase equipment or property and leases it to third parties, and in which the grantor or grantors have a beneficial interest in the trust and the power to manage the activities of the trust.

.37 Section 7701.—Definitions.—The classification of limited liability companies for federal income tax purposes.

.38 Section 7701.—Definitions.—The classification of separately tradeable instruments that are issued by a corporation as a unit, the components of which collectively contain the attributes of stock.

.39 Section 7701.—Definitions.—The classification of an instrument that has certain voting and liquidation rights in an issuing corporation but whose dividend rights are determined by reference to the earnings of a segregated portion of the issuing corporation's assets, including assets held by a subsidiary.

SEC. 6. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Procs. 87-3, 87-23, 87-30, 87-35, 87-37, 87-46, and 87-59 are superseded.

---

26 CFR 601.202: Rulings and determination letters.

Rev. Proc. 88-4

SECTION 1. PURPOSE

The purpose of this revenue procedure is to advise taxpayers and practitioners of a change in the mailing address for ruling requests on matters under the jurisdiction of the Associate Chief Counsel (International).

SEC. 2. APPLICATION

Section 6.01 of Rev. Proc. 87-4, 1987-1 C.B. 529, is changed to read as follows:

A request for a ruling or a closing agreement under the jurisdiction of the Associate Chief Counsel (International) must be submitted in duplicate to the Associate Chief Counsel (International), Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Requests may be hand delivered to Room 6561, 1111 Constitution Avenue, N.W., Washington, DC 20224. If the taxpayer fails to submit duplicate requests, the National Office will process the request in accordance with the provisions of section 6.11 (30-day close-out procedure) of this revenue procedure.

SEC. 3. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 87-4 is modified.

---

26 CFR 601.201: Rulings and determination letters.
(Also Part I, Section 412)

Rev. Proc. 88-5

SECTION 1. PURPOSE

The purpose of this revenue procedure is to modify the procedures for applications for waivers of the minimum funding standard under section 412(d) of the Internal Revenue Code and section 303 of the Employee Retirement Income Security Act of 1974 (ERISA), Public Law 93-406, 1974-3 C.B. 1, 41. The modifications will reflect changes made by the Single-Employer Pension Plan Amendments Act (SEPPAA), Title XI of the Consolidated Omnibus Budget Reconciliation Act of 1985, Public Law 99-272, 1986-2 C.B. 298, and the changes made by the Pension Protection Act, Part II of subtitle D of title IX of the Omnibus Budget Reconciliation Act of 1987 (OBRA), Public Law 100-203.

SEC. 2. BACKGROUND INFORMATION

.01 Revenue Procedure 83-41, 1983-1 C.B. 725, describes the procedure for requesting a waiver of the minimum funding standard under section 412(d) of the Code. Section 2.02 of the Revenue Procedure states that a request will not be considered unless certain specific documents described therein are included in the waiver application. Section 2.03 of the Revenue Procedure describes the necessary information that must be furnished by the applicant for the waiver.

.02 SEPPAA modified the provisions of the Code with respect to requirements relating to waivers. In particular, SEPPAA (1) added section 412(f)(3)(B) and (C) to require that the Service consult with the Pension Benefit Guaranty Corporation (PBGC) before granting or modifying a waiver under subsection 412(d) where the cumulative outstanding balance of the amount of waived funding deficiencies for a plan plus the amount of the waiver currently requested equals or exceeds $2,000,000 and (2) added section 412(f)(4), which provides that the Secretary, before granting a waiver under subsection 412(d) shall require each applicant to provide evidence satisfactory to the Secretary that the applicant has provided notice of the filing of the application for such waiver to each employee organization representing employees covered by the affected plan. OBRA modified section 412(f)(3) of the Code by striking out "$2,000,000" and inserting in lieu thereof "$1,000,000". In addition, OBRA amended section 412(f)(4)(A) of the Code to require that notice of application of a funding waiver also be given to each participant, beneficiary and alternate payee (within the meaning of section 414(p)(8)). Section 412(f)(4) also provides that the Secretary shall consider any relevant information provided by a person to whom such notice was given.

SEC. 3. CONSULTATION WITH PBGC

.01 Section 412(f)(3)(B) and (C) of the Code, as added by SEPPAA, requires that the Service provide the PBGC with notice of the completed application for any waiver and an opportunity to comment on such application within 30 days after receipt of such notice. Any information provided to the PBGC as a result of this provision shall be considered tax return information and is subject to the safeguards and reporting requirements of section 6103(p). The Service is not required to notify PBGC regarding applications where the outstanding balance of the amount of waived funding deficiencies for prior plan years plus the amount for which a waiver is currently requested is less than $2,000,000. This $2,000,000 threshold was reduced to $1,000,000 by OBRA.

.02 To expedite the procedures necessary to satisfy this requirement, section 2.03(d)(15) of Revenue Procedure 83-41 is modified to read as follows:

> "(15) A list of each of the prior 15 plan years for which a waiver was granted, the amount waived for such plan year, the outstanding balance of the amortization base established for the waiver, and the conditions, if any, placed upon the waiver. A copy of each waiver ruling letter must be submitted with the waiver request. The outstanding balance of the amortization base for each waiver is to be calculated as of the first day of the plan year for which a waiver is being requested."

.03 In addition, the first paragraph of section 2.03 of Revenue Procedure 83-41 is modified to add at the end thereof the following new sentence:

> "If the sum of the outstanding balances of any amortization bases established under section 412(b)(2)(C) of the Code for waivers granted to the plan for any prior plan years (calculated as of the first day of the plan year for which a new waiver is being requested) when added to the amount for which a waiver is currently being requested, equals or exceeds $1,000,000, the applicant must furnish two copies of the necessary waiver information described in this section 2.03."

SEC. 4. PROCEDURES FOR NOTICE AND SUBMISSION OF RELEVANT INFORMATION

Section 412(f)(4) states that the Secretary shall require each applicant for a waiver to demonstrate that the applicant has notified each employee organization representing employees covered by the affected plan that a waiver application has been filed. Accordingly, section 2.02 of Revenue Procedure 83-41 is modified to substitute a comma for the word "and" between "(1) and (2)" in the first sentence, insert, after "(2)" the words "and (3)," and to add the following paragraph (3):

"(3) The taxpayer must provide as part of the application a copy of a written notification signed by an appropriate officer of the taxpayer to each employee organization (union) representing employees covered by the affected plan and each participant, beneficiary, and alternate payee (within the meaning of section 414(p)(8) of the Code) that an application for a waiver of the minimum funding standard under section 412(d) of the Code has been submitted to the Service. The individual notice to participants, beneficiaries, and alternate payees may be in the form of a copy of a general notice which was signed by an appropriate officer of the company. The applicant must state that such notice was hand delivered or mailed to the last known address of the appropriate employee organization, participant, beneficiary, and alternate payee. If the applicant makes a reasonable effort to carry out the provisions of this paragraph, failure of an employee organization, participant, beneficiary, or alternate payee to receive the notice will not cause the applicant to fail the notice requirement. However, merely posting the notice on a bulletin board is not sufficient to satisfy this requirement. The notice must state that, under section 412(f)(4)(B) of the Code, the Service will consider any relevant information submitted. Further, the notice must specify the address to which information may be sent to the Service and state that because of the disclosure restrictions of section 6103 of the Code, the Service will not provide any information with respect to the waiver. The notice must also state that in accordance with section 104 of ERISA and section 2520.104b-10 of the Department of Labor regulations (29 CFR Part 2520) annual financial reports for the plan which include employer contributions made to the plan and the accumulated funding deficiency for the plan for any year are available for inspection at the U.S. Department of Labor in Washington, D.C., and that copies of such reports may be obtained upon request from the Public Disclosure Room, Room N-5507, Pension and Welfare Benefits Administration, U.S. Department of Labor, 200 Constitution Ave., N.W., Washington, D.C. 20210, upon payment of copying costs. In addition, the notice must state that copies of the latest annual report are available for inspection at the principal office of the plan administrator and any other location as required under section 104(b)(2) of the Employee Retirement Security Act of 1974 and the street address of such location. The notice must also state that copies of the annual report may be obtained from the plan administrator at a reasonable charge. The address to which requests for such copies may be sent and the amount of the charge must be stated. In addition, the notice must include a description of the extent to which the plan is funded for benefits which are guaranteed under Title IV of ERISA and the extent to which the plan is funded for benefit liabilities. Generally, this is satisfied if the notice includes the present value of the vested benefits, the present value of benefits determined as though the plan terminated, and the fair market value of plan assets, using the interest rate for calculating current liability. No additional information is required by the Service to be furnished to plan participants, beneficiaries, alternate payees or employee organizations as part of the waiver application process. Additional information may, of course, be provided by the employer pursuant to the collective bargaining process or otherwise.

SEC. 5. SUBMISSION OF COMMENTS

.01 Section 412(f)(4)(B), as added by SEPPAA, provides that the Secretary shall consider any relevant information provided by a person to whom notice was given as described in section 4 above. Section 6103 of the Internal Revenue Code prohibits the Service from disclosing return information with respect to any taxpayer. Accordingly, absent a disclosure waiver the Service may not reveal any part of the contents of any waiver application to any individual who wishes to submit relevant information concerning a waiver application. Moreover, the Service can neither confirm nor deny that a request for a waiver of the minimum funding requirement with respect to any particular pension plan has or has not been received.

.02 All relevant information submitted should be submitted in writing to the Commissioner of Internal Revenue, Attention: E:EP:PA; 1111 Constitution Avenue, N.W., Washington, D.C. 20224. Although no specific time period is provided within which the information is to be submitted, such information should be submitted as soon as possible after notice is received that a waiver application has been filed.

.03 The Service will not suspend action on a waiver request in order to wait for information from employee organizations. If, however, a ruling letter has been issued to the applicant and information is later submitted, the Service will review the information so submitted and revoke or modify the ruling letter if it is deemed appropriate to do so. Generally, information submitted will not cause a revocation or modification of the ruling letter unless the information indicates that there was a material omission or misstatement of facts.

SEC 6. TIME WHEN APPROPRIATE TO REQUEST A WAIVER

Section 414(d), as amended by OBRA, requires that an employer (other than an employer maintaining a multiemployer plan) seeking a minimum funding waiver for a plan year beginning after December 31, 1987, must submit the request on or before the 15th day of the 3rd month following the close of the plan year for which the waiver is requested. However, there is a transitional rule for plan years beginning in calendar year 1988, that permits requests to be filed on or before the 15th day of the 6th month following the close of the plan year for which the waiver is requested. Accordingly, the first sentence of the first paragraph of section 4 of Rev. Proc. 83-41 is replaced by the following sentences:

> "A waiver request for a plan year beginning on or before December 31, 1987, must be submitted no later than the close of the plan year following the plan year for which the waiver is requested. A waiver request for a plan year beginning after December 31, 1987, and before January 1, 1989, must be submitted no later than the 15th day of the 6th month following the close of the plan year. All other waiver requests must be submitted no later than the 15th day of the 3rd month following the close of the plan year for which the waiver is requested."

SEC. 7. TEMPORARY HARDSHIP AT THE CONTROLLED GROUP LEVEL

Sec. 2.03 of Rev. Proc. 83-41 is changed by inserting after the term "employer" where it first appears in the first sentence the phrase:

> "and all other entities included within the controlled group of which the employer is a member".

Sec. 2.03(b) of Rev. Proc. 83-41 is changed by inserting after the term employer in the first sentence the phrase:

> "and all other entities included within the controlled group of which the employer is a member."

SEC. 8. EFFECTIVE DATE

This revenue procedure is effective for all ruling requests received after the date of its publication in the Internal Revenue Bulletin. The provision in section 4 requiring that participants, beneficiaries and alternate payees be notified of waiver requests and the provision in section 4 requiring that such notification include a description of the extent to which guaranteed benefits and benefit liabilities are funded are applicable to requests submitted on or after March 22, 1988. The effective date of the provisions in section 6 with request to timely filing of waiver requests is based on the plan year for which the waiver is requested as stated in that section.

SEC. 9. EFFECT ON OTHER REVENUE PROCEDURES

Revenue Procedure 83-41 is modified.

---

26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 46, 167, 168; 1.46-3(g), 1.167(l)-2.)

Rev. Proc. 88-6

SECTION 1. PURPOSE

The purpose of this revenue procedure is to amplify section 8 (Instructions to Taxpayer) of Rev. Proc. 88-1, page 557, this Bulletin, and Rev. Proc. 85-57, 1985-2 C.B. 740, to ensure receipt of complete and adequate information in order to expedite the processing of requests for rulings from public utility taxpayers concerning the normalization requirements of sections 46(f), 167(*l*), and 168(i)(9) of the Internal Revenue Code.

SEC. 2. BACKGROUND

Section 8 of Rev. Proc. 88-1 provides instructions to taxpayers requesting rulings from the Internal Revenue Service. Although a request for ruling on normalization matters is submitted by the public utility taxpayer, the proposed matter is frequently initiated either by the regulatory commission that has ratemaking authority for the taxpayer or by a consumer advocate officially recognized by the regulatory commission. Because ratepayers have an interest in whether a public utility uses a normalization method of accounting, input from the regulatory commissions and consumer advocates can often help the Service by clarifying the issues involved in a request for rulings and by discussing the authorities that bear on those issues.

SEC. 3 SCOPE AND PROCEDURE

A ruling request involving the normalization requirements of sections 46(f), 167(*l*), and 168(i)(9) of the Code, ordinarily will not be considered unless the taxpayer states in the request for ruling whether:

(1) the regulatory authority responsible for establishing or approving the taxpayer's rates has reviewed the request and concluded that it is adequate and complete, and (2) the taxpayer will permit the regulatory authority to participate in any National Office conference concerning the request.

If the taxpayer or the regulatory authority informs a consumer advocate of the request for rulings and the advocate wishes to communicate with the Service regarding the request, any such communication should be sent to Internal Revenue Service, Associate Chief Counsel (Technical & International), Attention CC:C:2:6, Room 5238, 1111 Constitution Avenue N.W., Washington, D.C. 20224. These communications will be treated as third party contacts for purposes of section 6110 of the Code.

SEC. 4 EFFECT ON OTHER DOCUMENTS

Rev. Proc. 88-1 is amplified.

Rev. Proc. 85-57 is amplified and superseded.

SEC. 5 EFFECTIVE DATE

This revenue procedure will apply to all ruling requests submitted to the National Office after January 11, 1988.

---

26 CFR 601.602: Tax forms and instructions.

Rev. Proc. 88-7

SECTION 1. PURPOSE

This revenue procedure states the Internal Revenue Service (the Service) requirements relating to acceptable privately designed and printed or computer-prepared substitute federal tax return forms, (i.e., Forms 1040, 1040A, 1040EZ, 1120, 1120A, 940, 941, etc.) and computer-generated substitute schedules or forms to be attached thereto. It also authorizes the use of reproductions of official forms and gives direction for the proper completion of returns.

SEC. 2. SCOPE

This revenue procedure is the guide for preparing substitutes for most printed, computer-prepared and computer-generated tax forms. This procedure does not include guidance for Form 1040-ES, Form 1041-ES, Form 5498, Form 1096, the Form 1099 series, Form W-9 and the Form W-2 series. (See Sec. 18 and 19 to obtain guidance for the excluded forms). All other Internal Revenue Service tax forms, whether or not specifically mentioned herein by title or form number, are to be considered as covered by this general revenue procedure.

SEC. 3. DEFINITIONS

.01 *Substitute Form.* A tax form (or related schedule) that differs in any way from the official version and is intended to replace the entire form that is printed and distributed by the Service. This term also covers those approved substitute forms exhibited in this revenue procedure.

.02 *Printed (or Preprinted) Form.* A form produced using conventional printing processes. Also, a printed form which has been reproduced by photocopying or similar processes.

.03 *Preprinted Pin-Fed Form.* A printed form that has marginal perforations for use with automated and high-speed printing equipment.

.04 *Computer-Prepared Substitute Form.* A preprinted form in which the taxpayer's tax entry information has been inserted by a computer, computer-printer or other computer-type equipment, such as word-processing equipment.

.05 *Computer-Generated Substitute Form.* A form that is entirely designed and printed by the use of a computer printer on either lined or color-barred paper, so that all the line numbers, line captions, and the tax amount data entries are in the same computer typeface. No graphics usually appear on the form. (Most tax returns requiring signature and establishing tax liability may not be computer-generated. Among them are Forms 1040, 1040A, 1040EZ, 1120, etc.). The exhibits in the back of this revenue procedure are examples of computer-generated substitute forms.

.06 *Manually Prepared Form.* A pre-printed reproduced form in which the taxpayer's tax entry information is entered by an individual using a pen, pencil, typewriter, or other non-automated equipment.

.07 *Graphics.* Those parts of a printed tax form that are not tax amount entries or called-for information. Generally, these are line numbers, captions, shadings, instructions, special indicators, borders, rules, and strokes created by typesetting, photographics, photo-composition, etc.

.08 *Acceptable Reproduced Form.* A photocopy of an original form or of an unchanged reproduction proof supplied by the Service. (A reproduction is not a substitute form, but may subsequently be used as a computer-prepared substitute).

.09 *Supporting Statement (Supplemental Schedule).* A document providing detailed information to support an entry for a line(s) on an official or approved substitute form and filed with (attached to) a tax return. (A supporting statement is not a tax form and does not take the place of an official form, unless specifically permitted elsewhere in this procedure).

.10 *Specific Form Terms.* The following terms are used throughout this revenue procedure in reference to all substitute forms.

1. *Format.* The overall physical arrangement and general layout of a substitute form, as represented by the official form version.

2. *Sequence.* The same numeric and logical placement order of data, as reflected on the official form version. Sequence is an integral part of the total format requirement.

3. *Line Reference (Code).* The line numbers, letters or alpha-numerics used to identify each captioned line on the official forms; and printed to the immediate left of each caption or data entry field.

4. *Item Caption.* The textual portion of each line on the form, identifying the specific data elements required.

5. *Data Entry Field.* All areas designated on a form for the insertion of data, such as dollar amounts, quantities, responses, check-boxes, etc.

SEC. 4. MESSAGE TO TAX RETURN PREPARERS

.01 If you plan to change or modify *any* tax forms, you must follow these procedures, and, in many cases, you must get official approval before using substitute forms. The Service is continuing a program to identify and contact tax return preparers using unapproved forms that do not conform to this revenue procedure and impede processing of the return.

SEC. 5. HIGHLIGHTS OF PERMITTED CHANGES AND REQUIREMENTS

.01 THINGS YOU *CAN DO* TO INTERNAL REVENUE SERVICE PRINTED TAX FORMS TO MAKE THEM SUITABLE FOR USE AS SUBSTITUTE TAX FORMS WITHOUT PRIOR APPROVAL.

1. You can photocopy most tax forms and use them instead of the official ones. Generally, forms that totally conform to the requirements specified in this revenue procedure may be privately printed without prior approval. Proposed substitutes not conforming to these requirements must be submitted for prior approval.

(a) See excluded forms in .02.7 below.

2. You can reproduce any current tax form as cut sheets, snap-sets, and marginally-punched, pin-fed forms, so long as you use an official Service version as the master copy. Official versions are supplied by the Service, such as those in the taxpayer's tax package, those in Package X, those printed in revenue procedures, reproduction proofs sold by the Service, and over-the-counter forms available at IRS and other governmental public offices or buildings.

3. You can adjust the graphics on specified areas of printed Forms 1040 and 1040A (and other forms) to allow for computer-printed or word processor fill-in. Only the areas listed in this revenue procedure may be adjusted without specific prior approval.

4. You can print and duplicate the substitute "worksheet-type" versions of Schedules A and B of Form 1040 (see exhibits). The Service will accept these substitute schedules instead of the official versions. These Schedules serve different purposes. One allows the form to contain state tax information which is blocked out before filing with the service. The other allows the form to be used singly or as part of a snap-set.

.02 THINGS YOU *CANNOT DO* TO INTERNAL REVENUE SERVICE PRINTED TAX FORMS TO MAKE THEM SUITABLE FOR USE AS SUBSTITUTE TAX FORMS.

1. You cannot, without prior Service approval, change any Internal Revenue Service tax forms or use your own (non-approved) version, unless specifically permitted by this revenue procedure. Only minor changes are permitted to an official tax form, as OPM approval for IRS use was based on the specific format and content of each form submitted by IRS. Once approved, IRS does not have the authority to change (or to authorize changes to) the official forms.

2. You cannot adjust any of the graphics on Forms 1040, 1040A and 1040EZ (except in those areas specified in this revenue procedure) without prior approval from the Service.

3. You cannot use your own version of Schedule A (Form 1040) unless you first get it approved. The Service wants only one Schedule A—either yours or ours; yours needs prior approval from the Service.

4. With some exceptions, you cannot omit filling out pertinent referenced (numbered or lettered) lines of the official Schedule A (and other tax forms) when attaching a supporting statement. Exceptions to line completion requirements are listed in this revenue procedure.

5. You cannot use your own preprinted label on tax returns filed with the Service, unless you fully comply with the exception criteria specified in Section 17.06.

6. You cannot computer-generate the TAX RETURNS THEMSELVES (i.e., forms requiring signature and that establish tax liability; for example, Forms 1040, 1040A, 1040EZ, 1120, 940, 941, etc.). These forms must be either the official, Service forms or privately preprinted using conventional printing processes, photocopying or similar reproduction processes. The forms may be filled in by a computer, by a word processor, or the like, but the forms themselves must be printed like the Service versions are. First-time users of forms designed using computer graphics must receive prior written approval. (See Exception in Sec. 22).

(a) Schedules are considered to be an integral part of the tax return itself, and therefore cannot be computer-generated, when they have been assigned consecutive page numbers and printed contiguous with page one of the return. Form 706, United States Estate Tax Return is an example of this situation, where Schedules A through R are on pages numbered as part of the basic return and cannot be separately computer-generated.

(b) However, Schedule 1 of Form 1040A is an example of when a schedule can be acceptably computer-generated. Although IRS-printed as a continuation of Form 1040A; the two pages of Schedule 1 do not have consecutive page numbers, and may therefore be separated from 1040A and submitted as a computer-generated substitute schedule.

(c) A "tax return" must remain complete, with its signature covering the entire return including all its assigned or associated (numbered) pages.

7. Some Service forms should never be reproduced as photocopies, or submitted on carbon copies, for intended use as substitute forms. This is because only the original or official versions are acceptable for filing with the IRS, due to their use in critical Service programs that normally require use of only OCR scannable documents.

(a) Forms 1096, 1098, 1099-A, 1099-B, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-OID, 1099-PATR, 1099-R, 1099-S, 5498, 8109, and 8109-B are the major forms that fall in this excluded category.

(b) Most of these forms have the provision for assessment of penalties for the submission of non-OCR scannable versions. For further information, see Publication 1179 (revised annually).

.03 THINGS YOU CAN DO TO FILE COMPUTER-PREPARED/GENERATED FORMS. PRIOR APPROVAL IS NOT REQUIRED.

1. You can duplicate the approved, computer-generated formats of Schedules 1, A, B, C, D, E, F, R, SE, and Form 3903 (of this revenue procedure), and use them without prior approval.

2. You can fill in official Internal Revenue Service supplied forms using computer or word-processing equipment. Internal Revenue Service forms are designed for a vertical spacing of six lines to the inch, with money amount columns wide enough to allow for the computer printing of ten characters.

3. You can change certain specified areas on the Forms 1040 and 1040A (spelled out in the revenue procedures) to assist computer-printing requirements and to allow for a little more room on certain lines.

4. If you meet the requirements, standards, and qualifications of this revenue procedure, *you can*, without prior approval, computer-generate your own substitutes of the tax forms (except for actual tax returns) not exhibited here. (See Agreement in Sec 21).

SEC. 6. APPROVAL

.01 *Basic Requirements.* Preparers who desire to file substitute privately designed and printed tax forms and/or computer-generated and computer-prepared tax forms must develop such substitutes using these guidelines. These substitutes, unless excepted by revenue procedure, must be approved by the Service before being filed.

.02 *Requests for Approval.*

1. The Service cannot approve your substitute form until the official form has been published. Please propose your substitute after you have examined the official form.

2. You should know the Service revenue procedure relating to the official form before you attempt to alter the form to meet your needs. Any alteration of forms must be within the limits acceptable to the Service. It is possible that, from one filing period to another, a change in law or a change in internal need (processing, audit, compliance, etc.) may change the allowable limits for the alteration of the official form.

3. When specific approval of any substitute form is desired, a sample of the proposed substitute should be forwarded for consideration by letter to the Internal Revenue Service, Attention: Substitute Forms Program Coordinator, TR:R:R, 1111 Constitution Avenue, N.W., Washington, DC 20224. To expedite multiple forms approval, we prefer that your proposed forms be submitted in separate sets by return. For example, Forms 1040 and their normally related schedules or attachments should be separated from Forms 1120, etc., if at all possible. Schedules and forms (i.e., Forms 3468, 4136, etc.) that can be used with more than one type of return (1040, 1041, 1120, etc.) should be submitted only once for approval, regardless of the number of different tax returns they may ultimately be associated with.

4. As no Service office except the one specified in Section 6.02.3 above is authorized to approve substitute forms, unnecessary delay may result if forms are sent elsewhere for approval. All such forms must be forwarded to the above address for formal control, review, and official approval. No IRS office is authorized to allow deviations from this revenue procedure.

5. The Service does not review or approve the logic of specific software programs, nor confirm the calculations entered on forms output from those programs that are submitted for approval. The accuracy of the program itself remains the responsibility of the software package developer, distributor, or user. The Substitute Forms Program is primarily concerned with the pre-filing quality review of the final forms output, produced by whatever means, that are expected to be processed by IRS field offices.

.03 *When to Send Proposed Substitutes.* Proposed substitutes should be sent to the address listed in .02 above, as much in advance of the filing period for the form as possible. This is to allow adequate time for analysis and response and to permit notice to our field offices that your substitute is acceptable. Quarterly filed forms, such as the Form 941, must be submitted by the first day of the last month of the quarter.

.04 *Accompanying Statement.* When the sample substitute is submitted, there should be an accompanying statement that lists the form number of each substitute requested and details those items that deviate from the official form in position, arrangement, appearance, line numbers, additions, deletions, etc. Included with each of the items should be a detailed reason or justification for the change and an approximation of the number of forms expected to be filed.

.05 *Approval/Non-Approval Letter.* The Service sends a formal letter of approval/non-approval. Approval letters may contain qualifications for use of the substitutes. Non-approval letters may specify the changes required for approval, but also may require resubmission for approval. Telephone contact is used when warranted.

.06 *Duration of Approval.*

1. Approvals are good for only one calendar year (January through December) or, in the case of corporation tax forms (with the exception noted below), for the remainder of the quarters of the calendar year.

2. Please Note: In some cases each new filing season requires a new approval, even if the official form does not change. But see the exceptions in 3 and 4 below.

3. Exception: Quarterly tax forms in the 94X series (941, 942, etc.) are approved only for one quarter. Each new quarter requires a new approval.

4. Exception: Limited continued use of a change approved for one tax year may be allowed for the same form in the following tax year. See 07. below for the limitations and for other requirements. Examples of such changes are the use of abbreviated words, revised form spacing, compressed text lines, shortened captions, etc., which do not change the consistency of lines or text on the official forms.

.07 *Limited Continued Use of an Approved Change.*

1. If you received written approval of a previous tax year substitute form governed by this revenue procedure and wish to continue to use the approved change in your current tax year substitute form, you may revise your form to include this change and, without additional written approval, use it as a current tax year substitute form, provided you comply with the requirements in this revenue procedure. See exception in 2 below.

2. This means that if you received written approval for a specific change on a specific form last year, you may again make the same change on the same form this year, if the item changed is present on this year's official form. Thus, the change allowed in last year's approved substitute Schedule A, for example, can be continued in your new substitute for this year. The new substitute does not have to be sent to the IRS, and written approval is not required. However, the new substitute must conform to the official current year IRS form in other respects: date, Office of Management and Budget (OMB) approval number, sequence number, Paperwork Reduction Act Notice Statement, arrangement, item caption, line number, line reference, data sequence, etc. It must also comply with this revenue procedure—which may have eliminated, added to, or otherwise changed the guideline which affected the change approved last year. Additionally, you will be bound by the "Agreement" in Section 21.

3. Exception: Those written approvals which stated that the approved change or form would not be allowed in any other tax year, or for a temporary, limited, or interim approval pending resolution of a failure to meet one or more Service-prescribed requirements.

4. This authorization for continued use of an approved change is limited to the continuation of design logic from an immediately prior tax year substitute form to a current tax year substitute form.

.08 *Requested Copies.* In our letter of approval, *you may* be requested to send to the Service eleven (11) copies of each approved form. When received, the copies will be used to notify Internal Revenue Service Centers that your substitute forms are approved. The requested forms should be assembled in sets. A set constitutes a return with the related schedules and forms in the same order as they will be filed, i.e., Form 1040, Schedules A, B, C, etc., and associated Forms 2119, 2441, etc.

.09 *Responsibility.* Following the receipt of initial approval for a substitute forms package, or of a software output program to print substitute forms, it is the responsibility of the originator (designer or distributor) to provide each subsequent client firm or individual with the pertinent Service forms requirements which must be met for continuing acceptability. Examples of this responsibility include the use of prescribed print paper, font size, legibility, state tax data deletion, the legal requirement of the Paperwork Reduction Act Notice for informing all users of substitute forms of the official use and collection requirements stated in the instructions for the official IRS forms, completion of documents, etc.

.10 *Forms Approval Number.* The Substitute Forms Program Coordination Office, TR:R:R, will assign a unique forms approval number to each firm that submits substitute forms for approval. This will be a permanently assigned control number that should be used on every form created by a particular firm.

1. This number should be printed at the bottom left margin area on the first page of every substitute form.

2. The Forms Approval Number consists of 4-6 positions, consisting of the following example configuration: H7348

(a) The first position (an alpha character), identifies the individual assigning the number within the Service.

(b) The second position (a numeric digit), identifies the year of issue of a number.

(c) The third position (a numeric digit), identifies the IRS Service Center with responsibility within the geographic location of the firm's *home* or *national* office location.

(d) The fourth, fifth, and sixth positions will be used as required, to identify the assigned numeric approval number (i.e., 1, 22, or 333, etc.).

3. This number should not be used on optically scanned (OCR) forms.

SEC. 7. OFFICE OF MANAGEMENT AND BUDGET (OMB) REQUIREMENTS FOR ALL SUBSTITUTE FORMS

.01 *Legal Requirements of the Paperwork Reduction Act of 1980.* Public Law 96-511 requires that: (1) OMB approve all Service tax forms, (2) each IRS form contains (in the upper right corner) the OMB approval number and any expiration date, and (3) each IRS form (or its instructions) state why IRS is collecting the information, how it will be used, and whether or not the information is required to be furnished. This information *must* be provided to every user of any official or substitute tax forms.

.02 *Application to Substitute Forms.*

1. *Approval Number and Date Is Required.* All substitute forms must contain in the upper right corner (see Marginal Printing, Sec. 11.02.1(c)) the OMB number and any expiration date that is on the official form.

2. *Format Required (2 Options).*

(a) OMB No. XXXX-XXXX (preferred)

or

OMB # XXXX-XXXX

(b) OMB No. XXXX-XXXX (preferred)

Expires XXXXXX (mmddyy)

or

OMB # XXXX-XXXX

Expires XXXXXX (mmddyy)

3. *Required Explanation to Users of Substitute Forms.* You must also inform the users of your substitute forms of the Service use and collection requirements stated in the instructions for the official Service form. If you provide your users or customers with the official Internal Revenue Service instructions, page 1 of each form must retain the Paperwork Reduction Act Notice Statement as on the official forms (usually in the lower left corner of the forms). Otherwise, you must duplicate the material in the statement and add the phrase, "For Paperwork Reduction Act Notice, See Separate Instructions".

(a) If the Service instructions are not provided to users of your forms, the exact text of the Paperwork Reduction Act Notice must be furnished separately. This notice reads, "We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information."

(b) If Service instructions are not provided, a copy of the alternative statement provided to users of your forms must be included with the forms you submit for approval.

.03 *Obtaining OMB Number, Date and Statement.* The OMB approval number, expiration date, and use and collection requirements may be obtained from the official printed form (or its instructions), the reproduction proof (or instructions), or from the Service.

SEC. 8. GENERAL GUIDELINES

.01 *Official Form Is the Standard.* Because a substitute form is a variation from the official form, you should know the requirements of the official form for the year of use before you modify it to meet your needs. For the most frequently used tax forms, the quickest way to obtain an official form is to request reproduction proofs of these forms. (See Sec. 20.)

.02 *Design.* Each form must follow the design of the official form as to format, arrangement, item caption, line numbers, line references, and sequence.

.03 *State Tax Information Prohibited.* State tax information must not appear (be visible) on the federal tax return or associated form or schedule which is filed with the Internal Revenue Service, except where amounts are claimed on or required by the federal return, e.g., line 5, Schedule A (Form 1040). (See Sec. 12.05 Block Out Methods.)

.04 *Federal and State Columns.* When a form is designed with both federal and state columns, the federal column must be to the left of the state column and adjacent to the line caption. Again, state tax information must not be on a federal tax form.

.05 *Vertical Alignment of Amount Fields.*

1. When a form is to be computer-prepared, you may remove the vertical line in the amount field that separates dollars from cents. When a form is to be computer-generated, vertically align the amount entry fields where possible. You must also use one of the ten-character amount formats shown in Sec. 23.04. Amount fields may be "rounded off" to dollars only, where form instructions specifically permit such entries.

2. When a form is to be manually prepared, the federal column must have a vertical line or some type of indicator in the amount field to separate dollars from cents if the official form has a vertical line. The cents columns must be at least 1/8-inch wide.

.06 *Sequence Number.* Please note that most forms have a "sequence number" located just below the year designation in the upper right corner of the form. The Service uses this number to indicate the order in which forms are processed when filed with a return. On computer-prepared forms it must be printed no less than 12-point, bold-face type and centered below the form's year designation. On computer-generated forms, place this sequence number following the year designation for the tax form and separate with an asterisk. It is not necessary to duplicate the "Attachment Sequence No." wording, except for the actual number. (See Forms Exhibits at the end of this Revenue Procedure).

.07 *Sequence Numbers Required.* The sequence number is required on most Internal Revenue Service forms. Please note that some of the numbers necessarily change each year. The specific sequence numbers used on official IRS forms must be duplicated on the representative substitute form. If a sequence number is not provided on the official form, it is not required on a substitute of that form either.

.08 *Paid Preparer's Information and Signature Area.*

1. On Forms 1040A, 1040, and 1120, etc., the "Paid Preparer's Use Only" area may not be rearranged or relocated. You may, however, add three extra lines to the paid preparer's address area without prior approval. This applies to other tax forms as well.

2. On Form 1040EZ this information must be provided at the bottom of the form below the taxpayer's signature area. As an alternative, the printed Paid Preparer's Information and Signature Area from either a Form 1040 or 1040A may be attached to the bottom of Form 1040EZ.

.09 *Assemblage of Forms.* When filing a return (i.e., Form 1040), the return must be arranged in this order: (1) the tax return, (2) Form 1040 schedules and forms in sequence number order, (3) all others (Form 1120, 1120S, 1065, 1041, etc.), lettered schedules (Schedule D, etc.) in alphabetical order and numbered forms in numerical order (Forms 2220, 4626, etc.), (4) supporting statements in the same sequence as the forms they support, and (5) additional information required or voluntarily submitted. In this way, they are received in the order in which they must be processed. If you do not send them to us in this order, the Service has to delay the return package to disassemble them and place them in this order before processing is continued.

SEC. 9. PHYSICAL ASPECTS AND REQUIREMENTS: PAPER

.01 *Paper Content.* The paper must be:

1. Chemical wood writing paper that is equal to or better than the quality used for the official form;
2. at least 18 pound (17″ × 22″, 500 sheets); or
3. at least 45 pound (25″ × 38″, 500 sheets).

.02 *Paper Prohibited.* Carbon-bonded paper is prohibited from use for all substitute forms filed with the Service.

.03 *Paper with Chemical Transfer Properties—Limited Use.* Chemical transfer paper for all substitute forms may be used only when the following specifications are met.

1. Each ply within the chemical transfer set of forms must be labeled.
2. Only the top ply (ply one and white in color), the one which contains chemical on the back only (coated back), may be filed with the Service. For example, a set containing three plies would be constructed as follows: ply one (coated back), "Federal Return, File with IRS"; ply two (coated front and back), "Taxpayer's copy"; and ply three (coated front), "Preparer's copy."
3. The file designation, "Federal Return, File with IRS," for ply one must be printed in the bottom right margin (just below the last line of the form) in 12-point, bold-face type. It is not mandatory, but recommended, that the file designation, "Federal Return, File with IRS," be printed in a contrasting ink for visual emphasis.
4. Carbon Paper. We prefer that you do not attach any carbon paper to any return you file with the Service.

.04 *Paper and Ink Color.* We prefer that the color of paper substantially duplicate that of the original form. You may use white paper. This means that your substitute must be printed in black ink and may be on white or on the color paper the Service form is printed on. Forms 1040A, 1040EZ, and 1040 substitute reproductions may be in black ink without the colored screening. The only exception to this rule is Form 1041ES, which should always be printed with a very light gray shading in the color screened area (an alternative is the salmon color originally specified on the Service reproduction proof). This is necessary to assist us in expeditiously separating this form from the very similar Form 1040ES.

.05 *Page Size.* Substitute or reproduced forms and computer-prepared/generated substitutes may be the same size as the official form (8" × 11", in most cases) or they may be the standard commercial size (8 1/2" × 11") exclusive of pin-feed holes. The thickness of the stock cannot be less than .003 inch.

.06 *Lined Paper.* Computer-generated substitute forms must be submitted on quality lined, machine paper. Lined, color-barred paper (of any bar coloration) is also acceptable. Lined paper assists Service employees during processing of the returns by allowing speedy and accurate location of tax entries corresponding to line captions. The lines provide the basic means for eye-travel from one side of the form to the other, and significantly reduces processing errors. Only original forms should be filed with IRS, as copies frequently do not meet legibility requirements, especially copies of forms originally printed on color-barred paper stock.

.07 *Exceptions to Lined Paper Requirement.* If your printer has underlining capability, you do not have to use lined or color-barred paper so long as you consistently underline text lines on the form. The underlining must be a continuous line and extend from the left text margin to the right text margin and be the same length for all lines on the page. Also, the use of printed vertical and horizontal graphics can produce an acceptable linear image of the official form, and is an approvable exception on a case by case basis.

SEC. 10. PHYSICAL ASPECTS AND REQUIREMENTS: PRINTING

.01 *Printing Medium.* The private printing of all substitute tax forms must be by conventional printing processes, photocopying, computer-graphics, or similar reproduction processes.

.02 *Legibility.* All forms must have a high standard of legibility, both as to printing and reproduction and as to fill-in matter. The Service reserves the right to reject those with poor legibility. The ink and printing method used must ensure that no part of a form (including text, graphics, data entries, etc.) developes "smears" or similar quality deterioration, including any subsequent copies of reproductions made from an approved master substitute form; either during preparation or during Service processing.

.03 *Type Font.* Almost all federal tax forms are printed using "News Gothic" as the basic type font. We request that you use this type font when composing any substitute forms.

.04 *Image Size.* The image size of printed substitute forms should be as close as possible to that of the official form. You may omit any text on both computer-prepared and computer-generated forms that is solely instructional.

.05 *Title Area Changes.* To allow a larger top margin for marginal printing and more lines per page (see Sec. 11 below), the title line(s) for all substitute forms (not including the form's year designation and sequence code, when present), may be photographically reduced by 40 percent or reset as one line of type. When reset as one line, the type size may be no smaller than 14-point. You may omit "Department of the Treasury, Internal Revenue Service" and all reference to instructions in the form's title area.

.06 *Remove Government Printing Office Symbol.* When privately printing substitute tax forms, the Government Printing Office symbol and/or jacket number must be removed. In the same place, using the same type size, print the Employer Identifying Number (EIN) or the Social Security Number (SSN) of the printer or designer.

.07 *Printing On One Side of Paper.* While it is preferred that both sides of the paper be used for substitute and reproduced forms, resulting in the same page arrangement as that of the official form or schedule, the Service will not object if only one side of the paper is used.

.08 *Photocopy Equipment.* The Service does not undertake to approve or disapprove the specific equipment or process used in reproducing official forms, but requires only that the reproduced forms satisfy the conditions stated in the revenue procedures.

.09 *Reproductions.* Reproductions of official forms and substitute forms which do not meet the requirements of this revenue procedure may not be filed instead of the official forms.

.10 *Removal of Instructions.* You may remove all references to instructions. No prior approval is needed. One exception is that the statement "For Paperwork Reduction Act Notice, See Instructions", must be retained or a similar statement provided on each form.

SEC. 11. PHYSICAL ASPECTS AND REQUIREMENTS: MARGINS

.01 *Margin Size.*

1. The format of a reproduced tax return when printed on the page must have margins on all sides at least as large as the margins on the official form. This allows room for Service employees to make the necessary entries on the form during processing.

2. A one-half to one quarter inch margin must be maintained across the top, bottom, and both sides (exclusive of any pin-feed holes) of all computer-generated substitutes. The margin area is also used by Service employees to make necessary entries on the form during processing.

3. The marginal, perforated strips containing the pin-feed holes must be removed from all forms prior to filing with the Service.

.02 *Marginal Printing.*

1. *Non-Tax Material Allowed in Limited Areas.*

(a) On any 8- or 8 1/2-inch-wide Service or substitute form, you may print your logo, compnay or firm name, identifying and collation symbols, etc., in the *left half of the top margin.*

(b) With the exception of the actual tax return forms (i.e., Forms 1040, 1040A, 1040EZ, 1120, 940, 941, etc.), you may also print in the *left vertical margin* and in the *left half of the bottom margin.*

(c) Printing is never allowed in the *right half of the top* of the tax return form (i.e. Forms 1040, 1040A, 1040EZ, 1120, 940, 941, etc.). The Service uses this area to imprint a File Location Number for each return.

2. *Prior Approval Not Required.* Prior approval is not required for the marginal printing allowed in 1 above when used with the unchanged exhibits in this revenue procedure or when printed on an unofficial form, on a photocopy of an official form or on an (unchanged) IRS reproduction proof.

3. *Prior Approval Required.* The marginal printing allowance in 1 above is also the guide for the preparation of acceptable substitute forms. There is no exception to the requirement that no printing is allowed in the *right half of the top margin* of the tax return form.

SEC. 12. APPROVED SUBSTITUTE FORMATS FOR FORM 1040 SCHEDULES

.01 *Exhibits of Approved Formats.* Two sets of exhibits (Exhibits A-1, B-1, A-2 and B-2) are at the end of this revenue procedure. They are acceptable substitutes for the official forms. They are intended to be used in place of the official forms and may be used without prior approval. Both sets are usable for manual entry or computer preparation. Vertical spacing is six (6) lines to the inch. You may also refer to them as examples of how the guidelines in this revenue procedure may be used in some specific cases. Please note that the Service does not supply reproduction proofs for these exhibits.

.02 *Printing or Duplication of Exhibits A-1 and A-2 and B-1 and B-2.* You may (1) print these exhibits or (2) duplicate them photographically or by using photo-reproduction techniques, providing your printed or reproduced images are exactly like the ones in the exhibits. With the exception noted below, nothing can be changed.

.03 *EXCEPTION.* In Exhibit A-1 and A-2 you may change the areas containing "other" items (lines 1c, 7, 9b, 14b, 21 and 25) as follows: (1) the areas inside the perimeter of the boxes containing the dash-leaders (---) may be used to print any particular deduction item associated with the corresponding deduction category, and (2) the dash-leaders may be removed (but you may not change the amount column box size or position).

.04 *Exhibits A-1 and A-2.*

1. *Exhibit A-1.* This substitute Schedule A format may be used as a single sheet or as one of the copies of a snap-set. It is designed to be used in place of the official Schedule A (Form 1040).

2. *Exhibit A-2.* This substitute Schedule A format may be used as a single sheet when both federal and state tax information is placed on the same form.

3. *No State Tax Information.* No state tax information can appear on these forms when filed with the Form 1040. The state column may be present but the *state tax information must not be visible* when filed with the Service. We prefer that the entire state column be *completely blocked out.*

.05 *BLOCK OUT METHODS.* A suggested method to block out the state tax information is: (1) place the substitute form in a clear plastic folder, (2) on the folder, place a strip of opaque material the exact width and length of the column you wish to block out, then (3) photocopy the substitute form while still in the folder. The result will be a form with only the federal tax information visible. Another method is to take a black marking pen and, using either vertical or horizontal strokes, cross out the state figures. Carbon-interleaved sets may be used where the amounts entered in the state column are filled in with black carbon overprint. This copy may be filed with the return.

.06 *Exhibits B-1 and B-2.* These exhibits correspond to Exhibits A-1 and A-2, and the provisions in .04.1 and 2 above apply. Both of these exhibits are acceptable for use in place of the official Schedule B (Form 1040).

.07 *Exhibits A-1 and B-1 or A-2 and B-2.* These exhibits may be used as sets when the return calls for both Schedule A and B.

1. Acceptable computer-generated formats for the schedules usually attached to the Form 1040 are shown in the Exhibits section of this revenue procedure. The exhibits are for Schedules A, B, C, D, E, F, R, and

SE. Schedule 1 (Form 1040A) is also included. All are acceptable substitutes for the official forms. They are intended to be used (without change) in place of the official forms and may be used without prior approval. All lines (including those not used for tax information) must be printed. (Any change to text or format of an exhibit requires prior written approval.) Vertical spacing is six (6) lines to the inch. You may also refer to them as examples of how the guidelines in this revenue procedure may be used in specific cases.

2. A combination of upper and lower case print fonts is acceptable in producing the computer-generated forms included in this procedure.

3. An exhibit of Form 3903 is included as an example, to reflect the computer-generation of any other non-schedule tax forms. This same logic can be applied to any Service form that is normally reproducible as a substitute form.

SEC. 13. SPECIFICATIONS FOR FILING SUBSTITUTE SCHEDULES K-1

Prior approval is NOT required for a substitute Schedule K-1 that accompanies Form 1065 (for partnership), a Form 1120-S (for small business corporation), or a Form 1041 (for fiduciary) when the substitute Schedule K-1 meets all of the following requirements.

.01 The Schedule K-1 must contain the payer and recipient's name, address and SSN/EIN.

.02 The Schedule K-1 must contain all line items required for use by the taxpayer.

.03 The line items must be in the same order and arrangement as those on the official form.

.04 The line items must be numbered, titled, and/or captioned exactly as shown on the official form.

.05 Each taxpayer's information must be on a separate sheet of paper. Therefore, all continuously printed substitutes must be separated, by taxpayer, before filing with the Service.

.06 Schedules K-1 for recipients must have instructions for required line items attached.

.07 You may be subject to penalties if you file Schedules K-1 with the Service and furnish Schedules K-1 to partners, shareholders, or beneficiaries that do not conform to the specifications of this revenue procedure.

.08 The amount of each partner's, shareholder's, or beneficiary's share of each line item must be shown. The furnishing of a total amount for each line item and a percentage (or decimal equivalent) to be applied to such total amount by the partner, shareholder, or beneficiary does not satisfy the law and the specifications of this revenue procedure.

.09 If you file Schedules K-1 not conforming to the above specifications, IRS may consider these as not processable and return them to you to be filed correctly. You may also be subject to the penalty as mentioned in .07 above.

SEC. 14. REQUIRED PREPARATION OF FORMS

.01 *Completely Fill In Lines.* You must completely fill in all the specified numbered or referenced lines as they appear on the official forms on computer-prepared or generated forms, (not just the totals but all the items that make up the totals as well) before attaching any supporting statement (see Sec. 15 below for exceptions).

.02 *IRS Processing of Forms.* The Service processes the return based on information entered on the official forms or approved substitutes. References are made to attachments only as required by law and as requirements direct. When you fail to complete all the pertinent lines on the official forms, Service Tax Examiners have to locate the information on your attachment and write it on the proper line of the official form. This time consuming process causes delays in processing the return and increases the potential for errors both in transcription and in interpretation.

.03 *Notification of Preparers.* The Service is continuing a program to notify preparers who fail to meet the requirement to completely fill in lines.

SEC. 15. EXCEPTIONS TO LINE COMPLETION REQUIREMENTS

.01 *Zero Entries.* Detailed information for any deduction or income category may be omitted from the printout if the category total to be reported is zero. However, the substitute form must show the total (zero when applicable) for each category. This means when no tax information is applicable, leave the line blank.

.02 *Lines Captioned "Other" (All Forms).* It is not necessary to fill in every numbered or referenced line of tax forms when the line caption calls for "Other," i.e., "Other (itemize)," "Other (specify)," "Other (attach schedule)," etc. Examples of this exception are lines 1c, 7, 9b, 14b, 21 and 25 for Schedule A, Form 1040. When this occurs, you may use a supporting statement and enter only the total amount of these "Other" items on the line of the official form. However, we prefer that you use the space on the official form when it is adequate.

.03 *Schedule A (Form 1040).* All numbered and lettered lines must be filled in, if applicable. Supporting statements may be used to give the details of the totals entered on such lines but may not be used as substitute for a collection of lines. For example, the detailed information for "Taxes" may now be shown on a supporting statement (supplemental schedule) and only line 8 filled in. Lines 5 through 7 must also be completed. Also, for example the details of "State and local income taxes" may be shown on a supporting statement and the total of such taxes entered on line 5. Also, the total of itemized deductions must be entered on line 26.

.04 *Schedule B (Form 1040).* Lines 2 and 4 need not be filled in on the form. A supporting statement may be used for the details of interest and dividend income and the appropriate totals of such income entered on lines 3 and 5, unless nominee distribution or accrued interest criteria apply. (See the tax package instructions concerning interest and dividends.)

.05 *Schedule C (Form 1040).* All lines must be filled in when applicable, except the line where "Other expenses-list type and amount" is listed. (See instruction in .02 above). Also, all Questions A through M must be present and answered.

.06 *Schedule E (Form 1040).*

1. When there are entries on page 1 for any of Part I, the following requirements must be met: (1) In Part I, lines 1, 2, and 3, the ques-

tions must be answered and tax information must be entered on the lines provided.

2. Supporting statements may be used for the details of rental and royalty income and expenses. The appropriate totals must be carried over and entered in the total column for lines 4, 5, 12, 20, 21 and 25 through 29.

3. Part II (page 2)—The income and loss from various partnerships, estates or trusts, small business corporations, etc. also may be detailed on a supporting statement, but the appropriate total income and total loss must be entered on lines 30 through 43.

4. As applicable, either page 1 or page 2 may be filed separately and independently of each other, as a valid Schedule E. Both pages are not required, unless the entered tax data applies to all parts of the form.

.07 *Schedule F (Form 1040).* If the cash method is used, only page one is needed. Otherwise both pages one and two must be entirely printed. Page two cannot be filed separately.

SEC. 16. SUPPORTING STATEMENTS

.01 *Use of Supporting Statements.* Supporting statements are to be used to explain an individual line entry on an official or substitute form. Unless specifically authorized by this revenue procedure (see Sec. 15), they must not be used to avoid completing required lines on the official form, or in lieu of a prescribed official schedule or form. Supporting statements are never to be used until the required official return or form they support are first totally filled in (completed). It is not acceptable to submit a blank or incomplete official form that refers to a supporting statement, and then to submit the form data entries solely on the statement, in lieu of completing a tax return or form.

.02 *Supporting Statements.* Supporting statements must: (1) provide details and explain entries made on the official form, (2) furnish all required information in the same sequence as called for on the official form, (3) furnish any additional information in the order of appearance on the form to which it refers, and (4) show taxpayer's name and social security number (SSN) or employer identification number (EIN), as applicable, and (5) clearly identify which official form it supports.

.03 *Cross-Reference.* Each supporting statement must be referenced to the form it supports, and the entry on the form must be cross-referenced to the supporting statement. For example, put "Statement X" on the top of the supporting statement that contains the identified line number and the supporting information, and put "See Statement X" on the line of the form that references the statement.

.04 *Extent of Use.* You may attach supporting statements to explain or support any line item on an official or approved substitute form.

.05 *Assemblage.* For filing purposes, supporting statements are not attached directly to their related forms. Rather, all supporting statements are assembled in the same sequence as the forms they support; they are then placed at the back of the form package, after the lettered and numbered forms (See Sec. 8.09).

.06 *Multiple Supporting Statements.* Supporting statements for each numbered or lettered form must have a separate page for its supporting statement(s). Each page should be the size of the form it supports, or it may be 8" × 11" or 8 1/2" × 11".

.07 *Not Reviewed for Approval.* The Service does not give its approval for specific supporting statements. The taxpayer or the tax practitioner for the taxpayer, must meet the needs as they arise, using the guidelines in this revenue procedure.

SEC. 17. SPECIFICATIONS FOR FILING SUBSTITUTE FORMS

.01 *Filing Substitute Forms.* Follow the same instructions as for filing official forms. These instructions are in the taxpayer's tax package.

.02 *Computer-Prepared Tax Forms.* For filing purposes the Service will accept computer-prepared tax returns (i.e., Forms 1040, 1040A, 1040EZ, 1120, 940, 941, etc.) filled in by a computer or a word-processing equipment or similar manual equipment, but these forms must be pre-printed.

.03 *Computer-Generated Forms.* For filing purposes, the Service will accept computer-generated versions of forms that are attached to individual and business income tax returns, provided the substitutes and their manner of completion meet the guidelines prescribed herein.

.04 *Combination of Manually Prepared and Computer-Prepared/Generated Forms.* For filing purposes, the Service will accept substitute tax forms that contain a combination of computer-prepared/generated and manually filled in information.

.05 *Taxpayer and Preparer Signatures.* All taxpayer signatures on forms to be filed with the Service must be original signatures, affixed subsequent to the reproduction process. However, the income tax preparer can satisfy the manual signature requirement by signing a completed income tax return form, making a photocopy of the return form, and having the taxpayer sign and file the photocopy. (See Rev. Rul. 78-370, 1978-2 C.B. 336).

.06 *Use Preaddressed Label Information.* When filing substitute or reproduced forms, use either (1) the preaddressed label included in the tax package the Service sent to the taxpayer, (2) your own printed label, duplicating exactly the SSN and all the name and address information from the Service label, including the two alpha characters preceding the Social Security Number, or (3) the printed alpha characters preceding the SSN, the SSN, and all name and address information in the same format as printed on the Service label. Use of this label information avoids larger processing costs because it reduces the potential for error—the kind of error which can delay the receipt of refund and information needed by the taxpayer, as well as significantly reducing the processing time for each return.

1. If taxpayer name(s) or address are incorrect on the Service label, line out old name(s) or address and insert corrected information on the preaddressed label provided ((1) above). In (2) and (3) above, print corrected name(s) or address on your duplicated label or in the appropriate form area, as applicable. NOTE: Whenever a correction is made to name(s) and/or address, DO NOT

print the two alpha characters located in the upper left corner (preceding the SSN) of all Service preaddressed labels.

2. If you propose printing your own (substitute) return label ((2) above), or propose printing name and address information directly on tax forms ((3) above), you must first forward the Service an example of your printed label or entity data format as it will appear on your forms, for approval prior to actual use. Mail your format examples for approval to the office specified in Section 6 of this Revenue Procedure.

3. The only acceptable computer-generated format, to be used on a substitute label or to be printed directly on tax forms, is shown in the Exhibit Section of this Revenue Procedure.

.07 *Use Internal Revenue Service Envelope*. When filing substitute or reproduced forms, use the envelope enclosed with the taxpayer's tax package. This envelope is coded for sorting into several categories. Use of the coded envelope can help speed up the processing and reduce processing costs. Do not use the Service-provided, tax-package envelope for other correspondence with the Service, as its misuse can delay the correspondence. (See Section 37 for the only acceptable exception to the use of official IRS envelopes).

.08 *Voluntarily Submitted Information*. Additional information required or voluntarily submitted should be on the same size paper as the official form and attached to the return following the supporting statements. (See Sec. 8.09.)

SEC. 18. GUIDANCE FROM OTHER REVENUE PROCEDURES

.01 Guidance for the substitute tax forms covered in this revenue procedure and the revenue procedures which govern their use, are as follows:

1. Revenue Procedure 87-38, IRS Publication 1355, Substitute Form 1040-ES Requirements.

2. Revenue Procedure 87-25, IRS Publication 1141, Specifications for Private Printing of Substitute Forms W-2P, and W-3.

3. Revenue Procedure 86-7, IRS Publication 1149, Magnetic Tape Reporting for Windfall Profit Tax Information Returns.

4. Revenue Procedure 87-17, IRS Publication 1179, Requirements for Reproducing Paper Substitutes of Forms 1096, 1098, 1099 Series, 5498, and W-2G.

5. Revenue Procedure 86-40, IRS Publication 1187, Filing Forms 1042S on Magnetic Tape.

6. Revenue Procedure 85-40, IRS Publication 1220, Requirements and Conditions for Filing Information Returns in the Forms 1099, 5498, and W-2G Series on Magnetic Tape.

7. Revenue Procedure 83-63, IRS Publication 1223, Specification for Private Printing of Substitute Forms W-2C and W-3C.

8. Revenue Procedure 84-65, IRS Publication 1253, Requirements and Conditions for Filing Information Returns in the Forms 1099, 5498, and W-2G Series on Cassette or Mini-Disk.

9. Revenue Procedure 85-47, IRS Publication 1255, Requirements and Conditions for Filing Information Returns in the Forms 1098, 1099, 5498, and W-2G Series on Magnetic Diskette.

10. Revenue Procedure 86-32, IRS Publication 1311, Requirements and Conditions for Filing Information Returns in the Forms 1098, 1099, 5498 and W-2G Series on 5 1/4 Magnetic Diskette.

SEC. 19. ORDERING REVENUE PROCEDURES

.01 If you receive Publication 1045, Information for Tax Practitioners, you may use the Form 3975K, Order Blank for Revenue Procedures, contained therein to order the following revenue procedures:

1. Pub. 1141, the revenue procedure on specifications for private printing of Forms W-2, W-2P, and W-3.

2. Pub. 1149, the revenue procedure on magnetic tape reporting for Windfall Profit Tax (Forms 6248).

3. Pub. 1167, the revenue procedure on substitute printed, computer-prepared, and computer-generated tax forms and schedules.

4. Pub. 1179, the revenue procedure on paper substitute information returns (Forms 1099, 1098, 5498, 1096, and W-2G).

5. Pub. 1192, Catalog of Reproducible Forms and instructions.

6. Pub. 1220, the revenue procedure on magnetic tape reporting for information returns (Forms 1099, 1098, 5498, and W-2G).

7. Pub. 1223, the revenue procedure on substitute Forms W-2c and W-3c.

8. Pub. 1253, the revenue procedure on magnetic cassette/mini-disk reporting for information returns (Forms 1099, 1098, 5498, and W-2G).

9. Pub. 1255, the revenue procedure on magnetic diskette reporting for information returns (Forms 1099, 1098, 5498, and W-2G).

10. Pub. 1311, the revenue procedure on 5 1/4 inch magnetic diskette (Forms 1099, 1098, 5498, and W-2G).

11. Pub. 1345, Specifications for Electronic Filing of Income Tax Returns (Tax Year 1987).

12. Pub. 1346, Electronic Return File Specifications for Individual Income Tax Returns (Tax Year 1987).

13. Pub. 1347, Electronic Return Record Layouts for Individual Income Tax Returns (Tax Year 1987).

.02 The above listed revenue procedures may be obtained also by writing to: Internal Revenue Service Publications, P.O. Box 25866, Richmond, VA 23260. Be sure to order using IRS Publication number.

SEC. 20. ORDERING REPRODUCTION PROOFS

.01 The Service provides for the public camera-ready, reproduction proofs of many of its printed tax forms. These reproduction proofs can only be ordered by using Form 6747, Order for Reproduction Proofs. Form 6747 can be obtained by written request to Internal Revenue Service, PM:S:FM:P, Attention: Reproduction Proof Coordinator, Room 1528, 1111 Constitution Ave., N.W., Washington, DC 20224.

1. Recorded forms distribution information is continuously available, and may be accessed by dialing 202-566-2473 or 2474 (not toll-free numbers). This recording provides for the receipt of form requests and inquiries at the end of the taped message.

.02 Basic specifications, such as margin, pagination, etc., will be printed in the margins of the reproduction proofs and must be removed before printing. The official reproduction proof margins across the top, bottom, and sides must be maintained on all reproductions and substitute forms.

.03 A charge of $1.00 per page will be made for each reproduction proof regardless of page size. After an order has been filled, invoices will be mailed to the requestor.

SEC. 21. AGREEMENT

Any person or company who uses substitute forms and makes all or part of the changes specified in this revenue procedure, agrees to the following stipulation: The Service presumes the changes are made in accordance with these procedures and, as such, will be noninterruptive to the processing of the tax return. Should any of the changes prove to be not exactly as described, and as a result become disruptive to the Service during processing of the tax return, the person or company agrees to accept the determination of the Service as to whether or not the form may continue to be used during the filing season, and also agrees to work with the Service in correcting noted deficiencies. Notification of deficiencies may be made by letter, phone call, or both.

SEC. 22. CONDITIONS—TAX FORMS (1040A, 1040EZ, 1040, 1120, 940, 941, Etc.)

.01 PROHIBITED FORMS.

1. COMPUTER-GENERATED VERSIONS.

Computer-generated versions of a tax return form (e.g., Form 1040, 1040EZ, 1040A, 1120, 940, 941, etc.) which requires a signature are not permitted. Only preprinted substitutes of these forms are allowed (e.g., Reproductions that contain manually entered or computer-prepared entries). Approval is extended to consider certain types of computer-generated graphic formats as acceptable "preprinted" substitutes. All such forms must have formal approval prior to their use.

2. COMPUTER-GENERATED GRAPHICS—First Time Users

First-time users who design substitute forms using computer-graphics (e.g. laser printing, dot matrix addressable printing, etc.) must receive prior approval before using them. Exception: Experienced users who have previously received written approval from the Service for tax forms do not need written approval before using their forms. This assumes that all new requirements for the tax year have been fully complied with, based on actual comparison with the final versions of the official IRS forms. However, users are bound by the agreement in Sec. 21.

.02 FILL-IN INFORMATION.

The tax return form itself (i.e., 1040, 1040A, 1040EZ, 1120, 940, 941, etc.) may be filled in by a computer printer or other similar automated equipment, but the form itself must be created beforehand (i.e. preprinted) using conventional printing methods, photocopying, computer-graphics (laser printing) or other similar reproduction processes.

.03 CHANGES PERMITTED TO THE FORMS 1040, 1040A & 1040EZ.

1. Certain changes (listed below) are permitted to the graphics of the form without prior approval, but these changes apply only to preprinted forms as described in .02 above.

2. Changes not requiring prior approval are good only for the annual filing period, which is the current Tax Year.

3. Other Changes Not Listed. All changes not listed here require prior approval from the Service BEFORE the form may be filed with the Service.

SEC. 23. CHANGES PERMITTED TO GRAPHICS (FORMS 1040A, 1040 AND 1040EZ).

Changes Permitted to the Graphics on Forms 1040, 1040A and 1040EZ and, Where Applicable, on Other Forms as Well for Use With Computer-Prepared (i.e. printed forms *Only*).

.01 *Adjustments.*

You may make minor vertical and horizontal spacing adjustments to allow for computer or word-processing printing. This includes widening the amount columns or tax entry areas so long as the adjustments do not exceed other provisions stated in revenue procedures. No prior approval is needed for these changes. However, the user of forms with such changes are bound by the "Agreement" in Section 21.

.02 *Name and Address Area.*

1. The horizontal rules and instructions within the name and address area may be removed and the entire area left blank; no line or instruction can remain in the area. However, the statement regarding use of the IRS mail label should be retained.

2. The heavy ruled border (when present) that outlines the name and address area must not be removed, relocated, expanded or contracted.

3. Requirement Format

(a) When the name and address area is left blank, as provided in 1 above, the following format must be used when printing the taxpayer's name and address. Otherwise, unless the taxpayer's preprinted label is affixed over the information entered in this area, the lines must be filled-in as shown.

1st name line (35 characters maximum)
In-care-of name line (35 characters maximum)
Street address (35 characters maximum)
City, State (24 char. max.), one blank char., & zip (five char.)

(b) When there is no in-care-of name line, the name and address will consist of only three lines. Examples of the formats follow:

Example of name and address with no in-care-of name line:

JOHN AND MARY JONES
1234 ANYWHERE ST. APT 111
ANYTOWN, DC 12345

Example of name and address with in-care-of line:

JOHN AND MARY JONES
C/O THOMAS A. JONES
4311 SOMEWHERE AVE.
SAMETOWN, DC 54321

.03 *Social Security Number (SSN) AND Employer Identification Number (EIN) Area.*

1. The vertical lines separating the format arrangement of the SSN/EIN may be removed.

2. When the vertical lines are removed, the SSN and EIN formats must be 000-00-0000 or 00-0000000, respectively.

.04 *Cents Columns.*

1. You may remove the vertical rule that separates the dollars from the cents.

2. All entries in the amount column should have a decimal point following the whole dollar amounts whether or not the vertical line that separates the dollars from the cents is present.

3. You may omit printing the cents, but all amounts entered on the form must follow a consistent format. You are strongly urged to round off the figures to whole dollar amounts, following the official return instructions.

4. When printing money amounts, you must use one of the following ten-character formats: (a) 0,000,000. (b) 000,000.00

5. When there is no entry for a line, leave the line blank.

.05 *"Paid Preparer's Use Only" Area.*

1. On all forms, where present, the paid preparer's information area may not be rearranged or relocated.

2. You may add three lines and remove the horizontal rules in the preparer's address area.

3. Form 1040EZ preparers must sign the return and provide all other required information. This information should be provided at the bottom of the form below the taxpayer's signature area. (See Section 8.)

SEC. 24. CHANGES PERMITTED TO FORM 1040A GRAPHICS

No prior approval is needed for the following changes (for use with computer-prepared forms only):

.01 *Line 4.*

The line caption may be compressed vertically to one line (to allow for same line entry for the name of the qualifying child) by using the following caption:

"Head of household; child's name . . ." name field

.02 *Other Lines.*

Any line whose caption takes up two or more vertical lines may be compressed to one line by using contractions, etc., and by removing instructional references.

.03 *Page 2 (Form 1040A).*

All lines must be present and numbered in the order shown on the official form. These lines may also be compressed as in .02 above.

.04 *Color Screening.*

It is not necessary to duplicate the color-screening used on the official form. A substitute Form 1040A may be printed in black and white only, with no color screening.

SEC. 25. OTHER CHANGES PROHIBITED

No other changes to the Form 1040A graphics are allowed without prior approval.

SEC. 26. CHANGES PERMITTED TO THE FORM 1040 GRAPHICS

No prior approval is needed for the following changes (for use with computer-prepared forms only).

.01 *Line 4.* This line may be compressed horizontally (to allow for a larger entry area for the name of the qualifying child) by using the following caption:

"Head of household; child's name" (name field)

.02 *Line 6c.*

1 The vertical lines separating columns (1) through (5) may be removed. The captions may be shortened to allow a one-line caption for each column.

2 The number of lines for listing "dependents" may be expanded by compressing other noted areas and lines.

.03 *Other Lines.*

Any other line whose caption takes up two or more vertical lines may be compressed to one line by using contractions, etc., and by removing instructional references.

.04 *Line 21.*

1. This line may be expanded vertically to a maximum of 3 lines.

2. The amount entry box must remain a single entry.

.05 *Line 37.* You may change the line caption to read "Tax" and computer-print either the words "FROM TAX TABLES:" OR "FROM SCHEDULE/*FORM*" and computer-print the appropriate text.

.06 *Line 38.* You may change the caption to read: "Additional taxes from Form" and computer-print only the form(s) that apply.

.07 *Line 45.* You may change the caption to read: "General business credit from Form" and computer-print only the form(s) that apply.

.08 *Color Screening.* It is not necessary to duplicate the color-screening used on the official form. A substitute Form 1040 may be printed in black and white only, with no color screening.

SEC. 27. OTHER CHANGES PROHIBITED

No other changes to the Form 1040 graphics are permitted without prior approval.

SEC. 28. ACCEPTABLE FORMATS OF COMPUTER-GENERATED FORMS AND SCHEDULES

.01 Exhibits of acceptable computer-generated formats for the schedules usually attached to the Form 1040 are shown in the Exhibits section of this revenue procedure.

.02 Use of Acceptable Formats. If your computer-generated forms appear exactly like the exhibits, no prior authorization is needed.

.03 Changes to exhibits are not permitted without prior approval. Any change to the text or format of any of the exhibits requires prior written approval.

SEC. 29. COMPUTER-GENERATED FORMS NOT SHOWN AS EXHIBITS IN THIS REVENUE PROCEDURE.

.01 Those desiring to computer-generate forms not shown here may do so, but they must design such forms themselves by following the manner and style of those in the Exhibits section of this publication, and by taking care to observe other requirements and conditions stated here.

.02 Computer-generated forms so designed do not require prior approval from the Service. However, the user of such forms is bound by the "Agreement" in Sec. 21 above. The Service encourages the submission of all proposed forms for review and approval.

.03 If you wish, you may submit any substitute form to the Service for approval consideration, or you may submit only a representative sample of your forms.

SEC. 30. INSTRUCTIONS FOR PREPARING COMPUTER-GENERATED SUBSTITUTES

.01 *Format Arrangement.*

The format of each substitute schedule or form must follow the format of the official schedule or form as to item captions, line references, line numbers, sequence, form arrangement and format, etc. Basically try to make the form look like the official one, with readability and consistency being primary factors. Use periods and/or other special characters to separate the various parts and sections of the form. With the exceptions in .02 below, all line numbers and items must be printed even though an amount is not entered on the line.

.02 *Line Numbers.*

1. When a line on an official form is designated by a number or a letter, that designation (reference code) must be used on a substitute form.

2. The reference code must be printed to the left of the corresponding captioned line and also immediately preceding the data entry field even if there is no reference code immediately preceding the data entry field on the official form.

3. In addition, the reference code that is immediately before the data field must either be followed by a period or enclosed in parentheses. There also must be at least two blank spaces between the period or the right parentheses and the first digit of the data field. (See example below.)

4. A decimal point (i.e., a period) should be used for each money amount regardless of whether the amount is reported in dollars and cents or in whole dollars, or whether or not the vertical line that separates the dollars from the cents is present. The decimal points must be vertically aligned when possible.

Example:

5 STATE & LOCAL INC. TAXES	5.	495.00
6 REAL ESTATE TAXES............................	6.	
7 OTHER TAXES (LIST)	7.	198.00
or		
5 STATE & LOCAL INC. TAXES	(5)	495.00
6 REAL ESTATE TAXES...........................	(6)	
7 OTHER TAXES (LIST)	(7)	198.00

.03 *Multiple Page Forms.* With the exceptions noted below, when printing multiple page forms the entire form with all its parts and pages must be printed. When printed on continuous forms, they must be burst and pin-feed holes removed before filing with the return.

.04 *Exception to Forms that must be entirely printed in whole or in part.*

1. On Schedule E, it is not necessary to print both pages if data does not apply. Either page one or page two can be printed and filed separately.

2. On Schedule F, depending on which accounting method is used (cash or accrual), the following will apply. If the cash accounting method is used only page one of Schedule F needs to be printed. Otherwise both page one and two must be entirely printed. Page two cannot be filed separately.

SEC. 31. ADDITIONAL INSTRUCTIONS FOR ALL FORMS

.01 Internal control numbers and identifying symbols of the computer preparer may be shown on the substitute, if the use of such numbers or symbols is acceptable to the taxpayer and the taxpayer's representative. If shown, such information must not be printed in the top one-half inch clear area, from the center to the right edge, of any form or schedule requiring a signature. With the exception of the actual tax return form (i.e. Forms 1040, 1120, 940, 941, etc.), you may also print in the left vertical and bottom left margins. The bottom left margin you may use extends 3 1/2 inches from the left edge of the form. (See Sec. 11 for more information on this subject.)

.02 Descriptions for captions, lines, etc., appearing on the substitute forms may be limited to one print line by using abbreviations and contractions and by omitting articles, prepositions, etc. However, sufficient key words must be retained to permit ready identification of the caption, line or item.

1. Explanatory detail and/or intermediate calculations for derivation of fine line totals, may be included on the substitute. We prefer that such calculations be submitted in the form of a supporting statement. If intermediate calculations are included on the substitute, the line on which they appear may not be numbered or lettered. Intermediate calculations may not be printed in the right column. This column is reserved for official numbered and lettered lines that correspond to the ones on the official form. If a supporting statement is submitted, intermediate calculations or subtotals may be formatted at the preparer's option.

2. Text prescribed for the official form, which is solely instructional in nature, e.g., "Attach this schedule to Form 1040," "See instructions," etc., may be omitted from the substitute form.

3. Information for more than one schedule or form may not be shown on the same printout page. Except for high volume computer-generated Schedules A and B (Form 1040), almost any form may be continued on two or more pages if necessary. When a form is continued on two or more pages, clearly identify at the bottom of each page, including page 1, that is continued, e.g., "Page 1, Schedule C Continued." It is strongly recommended that a substitute form not exceed the same number of pages used for the official form.

(a) Both sides of the paper may be printed for multiple page official forms; but it is unacceptable to intermix single page schedules or forms, except for Schedules A and B which are printed back to back by the Service. For example Schedule E can be printed on both sides of the paper, because the official form is multiple page, with page two continued on the back. However, for example, do not print Schedule E on the front page and Schedule SE on the back, or Schedule A on the front and Form 3903 on the back, etc.). Both pages of a substitute form must match the official form version it represents, except that the back page may be blank if the Service form only contains form instructions thereon.

4. Identify all computer-prepared substitutes clearly; print the form

designation one-half inch from the top margin and one and one-half inches from the left margin; print the title centered on the first. line of print; and print the taxable year and, where applicable, the sequence number on the same line one-half to one inch from right margin. Include the taxpayer's name and SSN on all forms and attachments. Also print the OMB number and (when applicable) the forms expiration date, as reflected on the official form.

5. The state tax column may be present, but the state tax information must NOT be visible on the copy filed with the Service. When a form is designed with both federal and state columns, the federal column must be to the left of the state column and adjacent to the line caption.

6. Attach all payments (check or money order, no cash) to the front of the tax return.

7. Negative (or loss) monetary amount entries should be enclosed in brackets, or signed minus, to assist in the accurate computation and input of form data. On many official forms the Service pre-prints brackets in selected negative data fields, and these designations should be retained or inserted on affected substitute forms.

SEC. 32. FILING SUBSTITUTE FORMS WITH THE SERVICE

Follow the same instructions as for filing official forms. These instructions are in the taxpayer's tax package.

SEC. 33. SPECIAL FORM 1040EZ OPTICAL CHARACTER RECOGNITION (OCR) REQUIREMENTS

.01 The Form 1040EZ is designed in OCR format. IRS has the capability to machine read this form by optical character recognition (OCR) equipment (Scan-Optics-System 540 and Recognition Equipment Inc.—Input 80 Model B Scanner).

.02 It is optional to produce the 1040EZ substitute as a normal (black and white) reproduction, or as an actual OCR version. The following criteria applies if the form is to be OCR scannable. Otherwise, you may print this form under the previous general guidelines of this Revenue Procedure.

.03 An acceptable substitute OCR Form 1040EZ must generally be an exact replica of the official OCR reproduction proof with respect to layout, content and required OCR characteristics.

.04 The specific paper requirements which must be met for the development of a substitute (privately printed) OCR Form 1040EZ include the following:

1. Color and quality of paper—Paper must be white, OCR grade bond, with no fluorescent additives or water marks, and with zero rag content.

2. Reflectivity of paper—Must be 80% or greater.

3. Opacity—The paper opacity ratio must be 80% or more.

4. Paper Weight—Specified paper weight is 20 lb. OCR bond (.0035″).

5. Dirt—Must not exceed 10 parts per million.

6. Finish (smoothness)—Must be between 90 and 160 units (Sheffield).

7. Porosity—Paper should have a Gurley reading between 15 and 95.

8. Gloss—Paper with shiny or lustrous appearance (glossy) should be avoided.

9. Size—Form trim size must be 8″ × 11″.

.05 The specific ink requirements which must be met for this form include the following:

1. Print Color—The face of the form prints in black and green, the back prints in black only.

2. Ink—Green ink used must be highly reflective OCR type, such as Sinclaire and Valentine J-27975, or an exact match. Black ink used must be non-reflective.

3. Face Registration—Black to green must be .02″ (plus or minus) both horizontally and vertically.

4. Face Screen—Forms contain a green screened background equal to a 15% tone of a 110-line screen. Follow registration marks on reproproof for screen positioning. Handprint boxes are included on Page 1 of the reproduction proof and should be printed as a 50% value of the recommended OCR green ink. Inks used for handprint boxes must reflect at least 90% of the background on which it is printed as measured in the visible range.

5. Face Margins—Approximately 2/6″ head from top trimmed edge to screen (1/2″ to black image). 1/6″ outside from trimmed edges to screen. Exact margins are provided with reproduction proofs.

6. Back Margins—1/2″ head, 5/16″ foot, and 5/16″ sides.

.06 *Typography*—Type must be substantially identical in both size and shape with corresponding type on the official form reproduction proof.

.07 To assure proper alignment and position of hand-printed characters representing return lines 1 through 11 tax data, they must be hand printed (entered) into the preprinted amount field boxes on the form. A # 2 lead wooden pencil or blue or black ink pen (ball-point, fountain, or felt-tipped) are recommended as the writing tools which will consistently provide the required stroke width and print contrast on entered characters.

.08 Reading of handprinted characters requires adherance to the following techniques.

1. Enter numeric amount digits carefully and clearly. Fill at least 2/3 of the individual character box height, keeping the character within the box with no overlapping or touching characters. Specific required digit constraints are shown below.

2. When entering "fours", keep the top open.

3. When entering "one", do not use serifs.

4. When entering "twos", do not add extra loops.

5. All character lines must be connected, with no gaps.

.09 *Color Screening*. On a non-OCR Form 1040EZ *only*, it is not necessary to duplicate the color-screening used on the official form. A substitute (non-OCR) Form 1040EZ may be printed in black and white, with no color screening required.

.10 All the general and detailed provisions of this Revenue Procedure apply (in addition to this specific OCR Section) for the development of substitute OCR Forms 1040EZ.

SEC. 34. SPECIAL FORM 1120A OPTICAL CHARACTER RECOGNITION (OCR) REQUIREMENTS

.01 Form 1120A has been developed and designed in OCR format. This return will be read by Optical

Character Recognition (OCR) equipment (Recognition Equipment Inc.—Input 80 Model B Scanner), if submitted in acceptable OCR format.

.02 It is optional to produce the 1120A substitute as a normal (black and white) reproduction, or as an OCR scannable version. The following specific criteria applies if the substitute form is to be produced for OCR processing. Otherwise, you may print this form under the general guidelines of this Revenue Procedure.

.03 An acceptable substitute OCR Form 1120A must be an exact replica of the official reproduction proof with respect to layout, content and required OCR characteristics.

.04 The specific paper requirements for this form generally duplicate those specified in Section 33, with the following exception:

1. Size—Form 1120A trim size must be 8 1/2" × 11".

.05 The specific ink requirements which must be met for this form include the following:

1. Print Color—Black and Maroon.
2. Ink—Maroon ink must be highly reflective OCR type, such as Sinclair and Valentine J-31859, or an exact match. Black ink must be non-reflective.
3. Face Registration—Black to Maroon must be 0.015 (1/64)" (plus or minus) both horizontally and vertically.
4. Handprint Boxes—These handprint boxes (for IRS entries and use only) are included on Page 2 of the reproduction proof, and should be printed as a 50% screen value of the recommended OCR Maroon ink. Inks used for handprint boxes must measure .19 PCS or less when tested using MacBeth PCM-II tester 'C' scale.
5. Face margins—Minimum margins require 11 2/6" head, 1/2" left and right, and 5/16" foot.
6. Back margins—11 2/6" head, 1/2" left and right, and 5/16" foot. Exact margins are provided with reproduction proofs.

.06 *Typography*—Type must be substantially identical in both size and shape with corresponding type on the official form reproduction proof.

.07 All entries on an OCR Form 1120A must be either typed or machine printed, to permit OCR scanning. Otherwise the return will be manually processed.

.08 *Use Taxpayer's Preaddressed Label.* Reproduced OCR Forms 1120A must have ONLY the taxpayer's preaddressed label affixed to be processable as an OCR document. Substitute labels and handwritten name/address information is not acceptable.

.09 All general and detailed provisions of this Revenue Procedure apply (in addition to this specific OCR Section) for the development of substitute OCR Forms 1120A.

SEC. 35. SPECIAL FORM 941 OPTICAL CHARACTER RECOGNITION (OCR) REQUIREMENTS

.01 The Form 941 is designed in OCR format. The Service has the capability to machine read this form by Optical Character Recognition (OCR) equipment (Recognition Equipment Inc-Input 80 Model B Scanner), if submitted in acceptable OCR format.

.02 Effective with forms filed for the first quarter of 1988, the Form 941 should be produced only in OCR scannable format. The following specific criteria applies if the substitute form is to be produced for OCR processing.

.03 An acceptable substitute OCR Form 941 must be an exact replica of the official reproduction proof with respect to layout, content, and required OCR characteristics.

.04 The specific paper requirements which must be met for the development of substitute (privately printed) forms generally duplicate those specified in Section 33, with the following exception:

1. Size-Form 941 trim size must be 8 1/2" × 11".

.05 The specific ink requirements which must be met for these forms include the following:

1. Print Color—Black and Red
2. Ink—Red ink must be a highly reflective (not less than 80%) OCR type ink, such as Sinclair/Valentine J6983 or an exact match. Black ink reflectance must not be greater than 15%.
3. Handprint Boxes (including the numbers outside the boxes)—These handprint boxes (for IRS entries and use only) are included on the reproduction proof, and should be printed as a 50% screen value of the recommended OCR red ink. Inks used for handprint boxes must measure 15% or less when tested using the MacBeth or Kidder testers (see # 5 below).
4. Face Margins—Minimum margins require 1/2" head; center sides; and, 5/16" foot.
5. Testers—The following two print testers may be used for Form 941. Any other type tester must first be approved by the IRS.

(a) MacBeth PCM-II
Use 'C' scale. Range must be between .13 minimum to .19 maximum.

(b) Kidder 082 A
Use infrared scale. PSC values must fall in the range of .32 minimum to .38 maximum. White calibration disk must be set at 100%. Sensitivity must be set at "1".

SEC. 36. PAPER SUBSTITUTES FOR FORM 1042S

.01 Paper substitutes for Form 1042S that *totally conform* to the specifications contained in this procedure may be privately printed without prior approval from the Internal Revenue Service. Proposed substitutes *not conforming* to these specifications must be submitted for consideration.

1. The request should be submitted by November 15 of the year prior to the year the form is to be used. This is to allow the Service adequate time to respond and the submitter adequate time to make any corrections. These requests should contain a copy of the proposed form, the need for the specific deviation(s), and the number of information returns to be printed.
2. Form 1042S is subject to annual review and possible change. Withholding agents and form suppliers are cautioned against overstocking supplies of the privately printed substitutes.
3. Copies of the official form for the reporting year may be obtained from most Service offices. The Service provides only cut sheets (no carbon interleaves) of these forms. Continuous fan-fold/pin-fed forms are not provided.

.02 Instructions for Withholding Agents

1. Only original copies may be filed with the Service. Carbon copies and reproductions are not acceptable.

2. The term "Recipient's U.S. tax identifying no," for an individual means the social security number (SSN). The SSN consists of nine digits separated by hyphens as follows: 000-00-0000. For all other recipients, the term means employer identification number (EIN). The EIN consists of nine digits separated by one hypen as follows: 00-0000000. The tax identifying number must be in one of these formats.

3. Withholding agents are requested to type or machine print whenever possible, provide quality data entries on the forms (that is, use black ribbon, insert data in the middle of blocks well separated from other printing and guidelines), and take other measures to guarantee a clear sharp image. Withholding agents are not required, however, to acquire special equipment solely for the purpose of preparing these forms.

4. On corrected returns, the words CORRECTED RETURN must be typed in all capital letters in the top 1/4 inch, right of center margin. All required information must be completed on a corrected return since it replaces and supersedes the information return previously filed.

5. Substitute forms prepared in continuous or strip form must be burst and stripped to conform to the size specified for a single form before they are filed with the Service. The dimensions are found below.

(a) Computer cards are acceptable, provided they meet all requirements regarding layout, content, and size.

.03 Substitute Forms Format Requirements.

1. Privately printed substitute Forms 1042S must be *exact replicas* of the official forms with respect to layout and contents. Only the dimensions of the substitute form may differ and the printing of the Government Printing Office symbol must be deleted. The exact dimensions are found below.

2. Line 1 must be present, line 2 may be omitted if it is not needed. If line 2 is omitted, also omit line 3.

3. None of the boxes can be omitted. Each box (a through f) must be present and in the exact order. The box for each payment amount must contain the appropriate caption.

4. Color and Quality of Paper.

(a) Paper for Copy A must be white chemical wood bond, or equivalent, 20 pound (basis 17 × 22 – 500), plus or minus 5 percent. No optical brighteners may be added to the pulp or paper during manufacture. The paper must consist of principally bleached chemical woodpulp and be free from unbleached or ground woodpulp or recycled printed paper. It also must be suitably sized to accept ink without feathering.

(b) Copies B and C (For Recipient) and D (For Withholding Agent) are provided in the official assembly solely for the convenience of the withholding agent. Withholding agents may choose the format, design, color and quality of the paper used for these copies.

5. Color and Quality of Ink-All printing must be in a high quality nongloss black ink. Bar codes should be free from picks and voids.

6. Typography—Type must be substantially identical in size and shape to corresponding type on the official form. All rules on the document are either 1 point (0.015 inch) or 3 point (0.045). Vertical rules must be parallel to the left edge of the document; horizontal rules, parallel to the top edge.

7. Dimensions—The official form is 8 inches wide × 3 2/3 inches deep, exclusive of a 1/2 inch snap stub on the left side of the form. The snap feature is not required on substitutes.

(a) The width of a substitute Copy A must be a minimum of 7 inches and a maximum of 8 inches, although adherence to the size of the offical form is preferred. If the width of the substitute Copy A is reduced from that of the official form, the width of each field on the substitute form must be reduced proportionately. The left margin must be 1/2 inch and free of all printing other than that shown on the official form.

(b) The depth of a substitute Copy A must be a minimum of 3 1/3 inches and a maximum of 3 2/3 inches.

8. Carbonized forms or "spot carbons" are not permissible. Interleaved carbons, if used, must of good quality to preclude smudging and should be black.

9. Other Copies—Copies B and C are required to be furnished for the convenience of payees who are required to send a copy of the form with other Federal returns they file. Copy D may be desired as a withholding agent's record/copy.

.04 Additional Instructions

1. Arrangement of Assembly—if all four parts are present, the parts of the assembly shall be arranged from top to bottom as follows: Copy A (Original), "For Internal Revenue Service," Copies B and C, "For Recipient," and Copy D, "For Withholding Agent."

SEC. 37. PROCEDURES FOR PRINTING INTERNAL REVENUE SERVICE ENVELOPES

.01 Organizations are now permitted to produce substitute tax return envelopes. Use of substitute return envelopes that comply with the requirements set forth in this section will assist in delivery of mail by the Postal Service and facilitate internal sorting once the envelopes are received at the Internal Revenue Service Centers. The permanent five digit ZIP codes assigned to the ten service centers are listed below. These ZIP codes must be utilized when mailing returns to the prescribed service center.

ATLANTA GA	39901
KANSAS CITY MO	64999
AUSTIN TX	73301
PHILADELPHIA PA	19255
MEMPHIS TN	37501
ANDOVER MA	05501
CINCINNATI OH	45999
HOLTSVILLE NY	00501
OGDEN UT	84201
FRESNO CA	93888

.02 The sorting of returns by form type is accomplished by the preprinted bar codes on return envelopes that are included in each specific type of form or package mailed to the taxpayer. The 32 bit bar code located on the left and above the address on each envelope identifies the type of form that person is filing and assists the Service in consolidating like returns together for processing. Failure to use the envelopes furnished by the Service results in additional processing time and effort and possibly delays the timely deposit of funds, processing of returns and issuance of refund checks.

.03 The Internal Revenue Service will not furnish or sell preprinted tax return envelopes to taxpayers or tax practitioners. A suitable alternative has been developed which will accommodate the sorting needs of both the IRS and the U.S. Postal Service. The new alternative is based on the use of ZIP+4 or 9 digit ZIP Codes for mailing various types of tax returns to the different area service centers. Essentially, the Postal Service will utilize the first five digits of a ZIP Code to sort and deliver the mail and IRS will utilize the last four digits to identify and sort the various form types into separate groups for processing. The list of add-on four digits or +4 portion of the 9 digit ZIP Codes with the related form designations is provided below and are to become a permanent part of the five digit service center ZIP codes shown above.

ZIP+FOUR	FORM/PACKAGE
XXXXX-0001	1040A/EZ
XXXXX-0002	1040 Non-Bus
XXXXX-0003	1040 Bus & Farm
XXXXX-0005	941
XXXXX-0006	940
XXXXX-0007	942
XXXXX-0008	943
XXXXX-0011	1065
XXXXX-0012	1120
XXXXX-0013	1120S
XXXXX-0020	5500C
XXXXX-0024	5500EZ
XXXXX-0027	990
XXXXX-0031	2290

.04 The Internal Revenue Service will produce position/design sheets, OCR readable addresses with the appropriate ZIP+FOUR code(s) and Postnet bar code(s) as Reproduction Proofs. Position sheet specifications must be followed as to size, stock, printing positions, clear areas and ink. Orders for each specific form/package ZIP code proof will be processed under Section 20 of this Revenue Procedure.

1. Any deviations from the specifications outlined on the position/design sheets must be approved in advance. Use of preparer company names, addresses and logos are permissable so long as prescribed clear areas are not invaded. Use of carbon based ink is essential for effective address and bar code reading. Envelope construction can be of side seam or diagonal seam design. Continuous pinfed construction is not desirable, but is permissable if the glued edge is at the top. This requirement is firm as mail opening equipment is designed to slice or otherwise open the bottom edge of each envelope.

.05 The above procedures or guidelines are written for the user having envelopes preprinted. Many practitioners may not wish to have volumes of the different envelopes with differing ZIP Codes/form designations preprinted for reasons of low volume, warehousing, waste, etc. In this case, the practitioner can type or machine print the addresses with the appropriate ZIP Codes to accommodate sorting. If the requirements/guidelines outlined in this section cannot be met, then use of only the appropriate five digit service center ZIP Code is needed.

SEC. 38. PROCEDURE FOR SUBSTITUTE FORMS 5471

.01 *Instructions for Preparing Computer-Generated Substitute Form 5471.*

Paper substitutes for Form 5471 and the accompanying schedules that totally conform to the specifications contained in this procedure may be privately printed but must have prior approval and are subject to annual review from the Internal Revenue Service.

.02 Copies of the official form for the reporting year may be obtained from most Service Offices. The Service provides only cut sheets of these forms. Continuous fanfold/pin-fed forms are not provided.

.03 *Computer-Prepared Tax Forms.*

For filing purposes the Service will accept computer prepared tax Form 5471 filled in by a computer or by word processing equipment or similar automated equipment.

.04 Computer-Generated Forms.

For filing purposes, the Service will accept computer-generated versions of Form 5471 that are attached to individual and business income tax returns, provided the substitute and schedule meet the guidelines prescribed herein.

.05 *Combination of Manually Prepared and Computer-Prepared/Generated Forms.*

For filing purposes, the Service will accept substitute Forms 5471 that contain a combination of computer-prepared/generated and filled in information.

.06 *Format Arrangement.*

The format of each substitute schedule or form must be an exact replica of the official form, following the format of the official schedule and form as to item captions, line references, line numbers, sequence, form arrangement and format, etc. Basically try to make the form look like the official one, with readability and consistency being primary factors. Use periods and/or other special characters to separate the various parts and sections of the form. All line numbers and items must be printed even though an amount is not entered on the line. The substitute form should be on the same size paper as the official forms and schedules.

.07 *Line Numbers.*

When a line on the official Form 5471 is designated by a number or a letter, that designation must be used on the substitute form. In addition, the reference code that is immediately before the data field must either be followed by a period or enclosed in parentheses. There must also be at least two blank spaces between the period or the right praentheses and the first digit of the data field.

.08 *Filing Computer-Generated Substitute Forms 5471.*

Follow the same instructions as for filing official forms.

SEC. 39. ELECTRONICALLY FILED RETURNS

.01 Since the 1986 filing season, the Service has been accepting current processing year electronically filed refund returns. Electronic filing is a method by which qualified filers transmit tax return information directly to an IRS Center over telephone lines. Forms 1040, 1040A, and 1040EZ are transmitted in Form 1040 format.

1. The taxpayer signature does not appear on the electronic part of the tax return. The qualified electronic filer obtains it on Form 8453, U.S. Individual Income Tax Declaration for Electronic Filing. Forms W-2, W-2P, and W-2G are attached to the form as well as any other documents containing required signatures. In certain instances, a signed copy of the paper tax return will also be attached.

2. The electronically filed returns can be printed in hardcopy form via

laser printer. The transmitted computer language information is extracted and printed on the appropriate form. The words "Electronic Return—Do Not Process" are printed across the top of page 1 of Form 1040. The hardcopy is a facsimile of the original return. No Service Center Coding appears on the return. All coding is computer generated and appears on the output Code and Edit Sheet. The sheet is part of the hardcopy return and will be supplied for internal use only requests.

3. The following is a list of all the forms and schedules which can be filed electronically:

Form 1040, U.S. Individual Income Tax Return
*Form 1040A, U.S. Individual Income Tax Return
*Form 1040EZ, Income Tax Return for Single filers with no dependents
Schedule A, Itemized Deductions
Schedule B, Interest and Dividend Income
Schedule C, Profit or (Loss) from Business or Profession
Schedule D, Capital Gains and Losses and Reconciliation of Forms 1099-B
Schedule E, Supplemental Income Schedule
Schedule R, Credit for the Elderly and Permanently and Totally Disabled
Schedule SE, Computation of Social Security Self-Employment Tax
Form W-2, Wage and Tax Statement
Form W-2P, Statement for Recipients of Annuities, Pensions, Retired Pay or IRA Payments (when there is tax withholding)
Form W-2G, Statement for Recipients of Certain Gambling Winnings
Form 2106, Employee Business Expenses
Form 2119, Sale or Exchange of Principal Residence
Form 2441, Credit for Child and Dependent Care Expenses
Form 3903, Moving Expenses
Form 4562, Depreciation and Amortization
Form 6198, Computation of Deductible Loss from an Activity Described in Section 465(c)
Form 6251, Alternative Minimum Tax Computation
Form 6252, Computation of Installment Sale Income
Form 8283, Non-Cash Contributions
**Form 8582, Passive Activity Losses
**Form 8598, Computation of Qualified Residence Interest
**Form 8606, Non-Deductible IRA Contributions, IRA Basis, and Nontaxable IRA Distributions

**These Forms are being developed as a result of the Tax Reform Act of 1986 and tentatively planned for inclusion in the 1988 Program.

4. For specific information about Electronic Filing refer to Publication 1345, Specifications for Electronic Filing of Individual Income Tax Returns; Publication 1346, Electronic Return File Specifications for Individual Income Tax Returns; Publication 1347, Electronic Return Record Layouts for Individual Income Tax Returns.

SEC. 40. EFFECT ON OTHER DOCUMENTS

This revenue procedure supersedes Revenue Procedure 87-11, 1987-1 C.B. 546.

Exhibit A-1 (Preferred Format)

(Form 1040)

Department of the Treasury
Internal Revenue Service

Substitute Schedule A
Itemized Deductions

OMB No. 1545-0074

1987

Attachment
Sequence No. **07**

Name(s) as shown on Form 1040

Your social security number

Medical and Dental Expenses	1a	Prescription medicines and drugs, insulin, doctors, dentists, nurses, hospitals, insurance premiums you paid for medical and dental care, etc.	1a			
	b	Transportation and lodging	1b			
	c	Other (list—include hearing aids, dentures, eyeglasses, etc.) ▶	1c			
	2	Add lines 1a through 1c, and enter the total here	2			
	3	Multiply the amount on Form 1040, line 31, by 7.5% (.075)	3			
	4	Subtract line 3 from line 2. If zero or less, enter -0-. **Total** medical and dental ▶			4	
Taxes You Paid		**Note:** Sales taxes are no longer deductible.				
	5	State and local income taxes	5			
	6	Real estate taxes	6			
	7	Other taxes (list—include personal property taxes) ▶	7			
	8	Add the amounts on lines 5 through 7. Enter the total here. **Total** taxes ▶			8	
Interest You Paid		**Note:** If you borrowed any new amounts against your home **after** 8/16/86 and at any time in 1987 the total of **all** your mortgage debts was more than what you paid for your home plus improvements, attach Form 8598 and check here ▶ ☐				
	9a	Deductible home mortgage interest you paid to financial institutions (report deductible points on line 10)	9a			
	b	Deductible home mortgage interest you paid to individuals (show that person's name and address) ▶	9b			
	10	Deductible points	10			
	11	Deductible investment interest	11			
	12a	Personal interest you paid (see page 22) 12a				
	b	Multiply the amount on line 12a by 65% (.65). Enter the result	12b			
	13	Add the amounts on lines 9a through 11, and 12b. Enter the total here. **Total** interest ▶			13	
Contributions You Made	14a	Cash contributions. (If you gave $3,000 or more to any one organization, report those contributions on line 14b.)	14a			
	b	Cash contributions totaling $3,000 or more to any one organization. (Show to whom you gave and how much you gave.) ▶	14b			
	15	Other than cash. (You must attach Form 8283 if over $500.)	15			
	16	Carryover from prior year	16			
	17	Add the amounts on lines 14a through 16. Enter the total here. **Total** contributions ▶			17	
Casualty and Theft Losses	18	Casualty or theft loss(es) (attach Form 4684). (See page 23 of the Instructions.) ▶			18	
Moving Expenses	19	Moving expenses (attach Form 3903 or 3903F). (See page 24 of the Instructions.) ▶			19	
Miscellaneous Deductions Subject to 2% AGI Limit	20	Unreimbursed employee business expenses (attach Form 2106)	20			
	21	Other expenses (list type and amount) ▶	21			
	22	Add the amounts on lines 20 and 21. Enter the total.	22			
	23	Multiply the amount on Form 1040, line 31, by 2% (.02). Enter the result here	23			
	24	Subtract line 23 from line 22. Enter the result (but not less than zero) ▶			24	
Other Miscellaneous Deductions	25	Miscellaneous deductions not subject to 2% AGI limit (see page 24). (List type and amount.) ▶			25	
Total Itemized Deductions	26	Add the amounts on lines 4, 8, 13, 17, 18, 19, 24, and 25. Enter the total here and on Form 1040, line 33a ▶			26	

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Schedule A (Form 1040) 1987

Exhibit A-2 (Acceptable Format)

(Form 1040)

Department of the Treasury
Internal Revenue Service

Substitute Schedule A
Itemized Deductions

OMB No. 1545-0074

1987

Attachment
Sequence No. **07**

Name(s) as shown on Form 1040

Your social security number

Medical and Dental Expenses	1a	Prescription medicines and drugs, insulin, doctors, dentists, nurses, hospitals, insurance premiums you paid for medical and dental care, etc.	1a		
	b	Transportation and lodging	1b		
	c	Other (list—include hearing aids, dentures, eyeglasses, etc.) ▶	1c		
	2	Add lines 1a through 1c, and enter the total here	2		
	3	Multiply the amount on Form 1040, line 31, by 7.5% (.075)	3		
	4	Subtract line 3 from line 2. If zero or less, enter -0-.	4		
Taxes You Paid	5	State and local income taxes	5		
	6	Real estate taxes	6		
	7	Other taxes (list—include personal property taxes) ▶	7		
	8	Add the amounts on lines 5 through 7. Enter the total here.	8		
Interest You Paid		**Note:** If you borrowed any new amounts against your home **after** 8/16/86 and at any time in 1987 the total of **all** your mortgage debts was more than what you paid for your home plus improvements, attach Form 8598 and check here ▶ ☐			
	9a	Deductible home mortgage interest you paid to financial institutions (report deductible points on line 10)	9a		
	b	Deductible home mortgage interest you paid to individuals (show that person's name and address) ▶	9b		
	10	Deductible points	10		
	11	Deductible investment interest	11		
	12a	Personal interest you paid (see page 22)	12a		
	b	Multiply the amount on line 12a by 65% (.65). Enter the result	12b		
	13	Add the amounts on lines 9a through 11, and 12b. Enter the total here.	13		
Contributions You Made	14a	Cash contributions. (If you gave $3,000 or more to any one organization, report those contributions on line 14b.)	14a		
	b	Cash contributions totaling $3,000 or more to any one organization. (Show to whom you gave and how much you gave.) ▶	14b		
	15	Other than cash. (You must attach Form 8283 if over $500.)	15		
	16	Carryover from prior year	16		
	17	Add the amounts on lines 14a through 16. Enter the total here.	17		
Casualty and Theft Losses	18	Casualty or theft loss(es) (attach Form 4684). (See page 23 of the Instructions.)	18		
Moving Expenses	19	Moving expenses (attach Form 3903 or 3903F) (See page 24 of the Instructions.)	19		
Miscellaneous Deductions Subject to 2% AGI Limit	20	Unreimbursed employee business expenses (attach Form 2106)	20		
	21	Other expenses (list type and amount) ▶	21		
	22	Add the amounts on lines 20 and 21. Enter the total.	22		
	23	Multiply the amount on Form 1040, line 31, by 2% (.02). Enter the result here	23		
	24	Subtract line 23 from line 22. Enter the result (but not less than zero)	24		
Other Miscellaneous Deductions	25	Miscellaneous deductions not subject to 2% AGI limit (see page 24). (List type and amount.) ▶	25		
Total Itemized Deductions	26	Add the amounts on lines 4, 8, 13, 17, 18, 19, 24, and 25. Enter the total here and on Form 1040, line 33a	26		

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Schedule A (Form 1040) 1987

Exhibit B-1 (Preferred Format)

Substitute Schedule B
Interest and Dividend Income

Schedule B (Form 1040) 1987

08 OMB No. 1545-0074

Name(s) as shown on Form 1040. (Do not enter name and social security number if shown on other side.)

Your social security number

Part I Interest Income

If you received more than $400 in taxable interest income, you must complete Part I and list ALL interest received. If you received, as a nominee, interest that actually belongs to another person, or you received or paid accrued interest on securities transferred between interest payment dates, see page 24.

Interest Income		Amount
1 Interest income from seller-financed mortgages. (See Instructions and list name of payer.) ▶	1	
2 Other interest income (list name of payer) ▶	2	
3 Add the amounts on lines 1 and 2. Enter the total here and on Form 1040, line 8. ▶	3	

Part II Dividend Income

If you received more than $400 in gross dividends and/or other distributions on stock, complete Part II. If you received, as a nominee, dividends that actually belong to another person, see page 25.

Dividend Income				Amount
4 Dividend income (list name of payer—include on this line capital gain distributions, nontaxable distributions, etc.) ▶			4	
5 Add the amounts on line 4. Enter the total here			5	
6 Capital gain distributions. Enter here and on line 13, Schedule D.*	6			▨
7 Nontaxable distributions. (See Schedule D Instructions for adjustment to basis.)	7			▨
8 Add the amounts on lines 6 and 7. Enter the total here			8	
9 Subtract line 8 from line 5. Enter the result here and on Form 1040, line 10 ▶			9	

If you received capital gain distributions but do not need Schedule D to report any other gains or losses or to figure your tax (see the* ***Tax Tip* *under* ***Capital gain distributions*** *on page 10), enter your capital gain distributions on Form 1040, line 14. Write "CGD" on the dotted line to the left of line 14.*

Part III Foreign Accounts and Foreign Trusts

If you received more than $400 of interest or dividends, OR if you had a foreign account or were a grantor of, or a transferor to, a foreign trust, you must answer both questions in Part III.	Yes	No
10 At any time during the tax year, did you have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See page 25 of the Instructions for exceptions and filing requirements for Form TD F 90-22.1.)		
If "Yes," enter the name of the foreign country ▶	▨	▨
11 Were you the grantor of, or transferor to, a foreign trust which existed during the current tax year, whether or not you have any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520-A, or 926		

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Schedule B (Form 1040) 1987

Exhibit B-2 (Acceptable Format)

(Form 1040)
Department of the Treasury
Internal Revenue Service

Substitute Schedule B
Interest and Dividend Income

OMB No. 1545-0074
1987
08

Name(s) as shown on Form 1040.

Your social security number

Part I.—Interest Income

Interest Income		Federal
1 Interest income from seller-financed mortgages. (See Instructions and list name of payer.) ▶	1	
2 Other interest income (list name of payer) ▶	2	
3 Add the amounts on lines 1 and 2. Enter the total here and on Form 1040, line 8. ▶	3	

Part II.—Dvidend Income

Dividend Income		Amount
4 Dividend income (list name of payer—include on this line capital gain distributions, nontaxable distributions, etc.) ▶	4	
5 Add the amounts on line 4. Enter the total here	5	
6 Capital gain distributions. Enter here and on line 13, Schedule D	6	
7 Nontaxable distributions. (See Schedule D Instructions for adjustment to basis.)	7	
8 Add the amounts on lines 6 and 7. Enter the total here	8	
9 Subtract line 8 from line 5. Enter the result here and on Form 1040, line 10 ▶	9	

Part III.—Foreign Accounts and Foreign Trusts

	Yes	No
10 At any time during the tax year, did you have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See page 25 of the Instructions for exceptions and filing requirements for Form TD F 90-22.1.)		
If "Yes," enter the name of the foreign country ▶		
11 Were you the grantor of, or transferor to, a foreign trust which existed during the current tax year, whether or not you have any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520-A, or 926		

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Schedule B (Form 1040) 1987

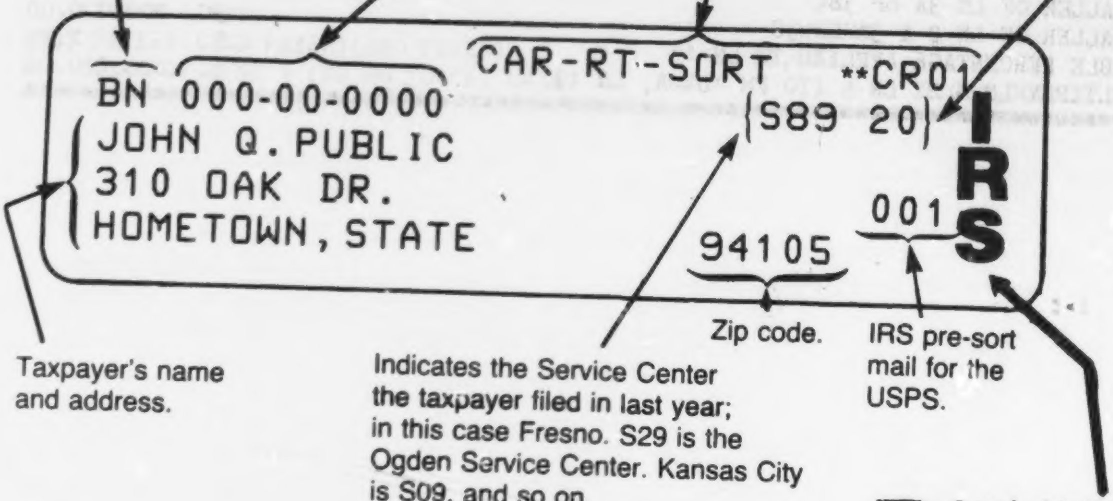
EXHIBIT LABEL (IRS PREPRINTED)

Check-Digit = Computer shorthand for taxpayer's name. By entering the two letters and the social security number, IRS can identify the correct account.

Taxpayer's social security number.

Indicates Postal Service home delivery route.

Signifies type of package mailed to the taxpayer.



Zip code.

IRS pre-sort mail for the USPS.

Taxpayer's name and address.

Indicates the Service Center the taxpayer filed in last year; in this case Fresno. S29 is the Ogden Service Center. Kansas City is S09, and so on.

NOTE: Certain labels will have either a PP, SS, or PL directly under the "S" in IRS. They indicate:

PP = Package (1st label in package)
SS = Sack (1st label in a sack)
PL = Pallet (1st label in a pallet)

These are used by the USPS for control purposes.

EXHIBIT LABEL (SUBSTITUTE)

Preprinted Label information needed from Practitioner in order for IRS to process "as if a label is used."

NOTE: Do not include the check-digit (2 alpha characters preceding the SSN) if there has been a change to either the taxpayer's name or address since last filing. Doing so will result in such things as delayed/erroneous refunds, processing delays, and IRS reviews, contacts, or corrections.

BN 000-00-0000
JOHN Q. PUBLIC
310 OAK DR.
HOMETOWN, STATE 94105

EXHIBIT CG - 1 (SCHEDULE 1 - PAGE 1)

```
SCHEDULE 1 INCOME AND DEDUCTIONS 1987
(FORM 1040A)                                                    OMB NO.  1545-0085
JOHN Q. AND MARY J. TAXPAYER                                    SSN  000-00-0000
**********************************************************************************
PART I CHILD AND DEPENDENT CARE CREDIT
1.  NO. OF QUALIFYING PERSONS CARED FOR IN 1987                  1.            XXX
2.  1987 EXPENSES INCURRED (MAX $2,400/$4,800)                   2.       0,000.00
3A. EARNED INCOME                                                3A.    000,000.00
 B. SPOUSE EARNED INCOME                                         3B.    000,000.00
 C. SMALLER OF LN 3A or 3B4                                      3C.    000,000.00
4.  SMALLER OF LN 2 & 3A OR 3C                                   3C.    000,000.00
5.  TABLE PERCENTAGE APPLIED TO LN 13                            5.           X.XX
6.  MULTIPLY LN 4 BY LN 5 (TO FM 1040A, LN 19)                   6.     000,000.00
**********************************************************************************
```

NOTE: This, and all such computer-generated forms must be printed on either lined or color-barred paper, See Section 9.06.

EXHIBIT CG-1 (SCHEDULE 1 - PAGE 2)

```
SCHEDULE 1 (CON'T)PAGE 2                                       1987
(FORM 1040A)                                         OMB NO. 1545-0085
JOHN Q. AND MARY J. TAXPAYER                              SSN  000-00-0000
*****************************************************************************
PART II INTEREST INCOME
1.  PAYERS (LIST)                                     AMOUNT
(1ST PAYER) (2ND PAYER) (3RD PAYER)                 00,000.00
2.  TOTAL OF LINE 1 (TO FM 1040A, LN 7A)                          2.000,000.00
*****************************************************************************
PART III DIVIDEND INCOME
1.  PAYERS (LIST)                                     AMOUNT
(1ST PAYER) (2ND PAYER)(3RD PAYER)                  00,000.00
2.  TOTAL OF LINE 1 (TO FM 1040A, LN 8)                           2.000,000.00
*****************************************************************************
```

EXHIBIT CG - A (SCHEDULE A)

```
                                                                1987 * 07
SCHEDULE A (FORM 1040)          ITEMIZED DEDUCTIONS         OMB NO. 1545-0074
                                                                SSN 000-00-0000
JOHN Q. & MARY J. TAXPAYER
**MEDICAL AND DENTAL EXPENSES*****************************************
  1A MEDICINE AND DRUGS,.............................................
     DOCTORS, DENTISTS, NURSES, HOSPITALS, ETC................ 1A.     00,000.00
     B TRANSPORTATION........................................1B.
     C OTHER (LIST)                                           1C.
       1st OR SEE STATEMENT XX
  2  ADD LINES 1A THRU 1C.....................................2.
  3  7.5% OF LINE 31, FORM 1040...............................3.
  4  SUBTRACT LN. 3 FROM LN. 2 (OR ZERO)......................4.
**TAXES***************************************************************
  5  STATE AND LOCAL INCOME.................................. 5.
  6  REAL ESTATE............................................. 6.
  7  OTHER (LIST) - 1ST OR SEE STATEMENT XX                   7.
  8  ADD LINES 5 THRU 7...................................... 8.
**INTEREST PAID*******************************************************
     FORM 8598 APPLICABLE + ATTACHED              (X)
  9A HOME MORTGAGE INTEREST TO FINANCIAL INSTITUTIONS.......... 9A.
   B HOME MORTGAGE INTEREST TO INDIVIDUALS (LIST)- 1st          9B.
  10 DEDUCTIBLE POINTS......................................... 10.
  11 DEDUCTIBLE INVESTMENT INTEREST............................11.
  12A PERSONAL INTEREST........................................12A.
  12B 65% OF LINE 12A                                          12B.
  13 ADD LINES 9A THRU 11 + 12B................................13.
**CONTRIBUTIONS*******************************************************
  14A CASH CONTRIBUTIONS UNDER $3,000..........................14A.
    B CASH CONTRIBUTIONS OF $3,000 AND OVER (LIST)             14B.
      1st OR SEE STATEMENT XX
  15 OTHER THAN CASH...........................................15.
  16 CARRYOVER FROM PRIOR YEAR ................................16.
  17 ADD LINES 14A THRU 16.................................... 17.
**CASUALTY AND THEFT LOSSES*******************************************
  18 TOTAL CASUALTY/THEFT LOSSES FROM FORM 4684............... 18.
**MOVING EXPENSE******************************************************
  19 MOVING EXPENSES FROM FORM 3903............................19.
**MISCELLANEOUS DEDUCTIONS SUBJ TO 2% AGI LIMIT **********************
  20 UNREIMBURSED EMPLOYEE BUSINESS EXP FROM FM 2106 ...........20.
  21 OTHER (LIST)-1st OR SEE STATEMENT XX                      21.
  22 ADD LINES 20 AND 21...................................... 22.
  23 2% OF LINE 31, FORM 1040..................................23.
  24 SUBTRACT LN. 23 FROM LN. 22 (OR ZERO).....................24.
  ** OTHER MISC DEDUCTIONS********************************************
  25 MISCELLANEOUS DEDUCTIONS NOT SUBJ TO 2% AGI...............25.
  ** TOTAL ITEMIZED DEDUCTIONS****************************************
  26 ADD LINES 4, 8, 13, 17, 18, 19, 24, AND 25.
     (ENTER ON FM 1040, LN. 33A)                             26.      00,000.00
  ********************************************************************
     FOR PAPERWORK REDUCTION ACT NOTICE, SEE SEPARATE INSTRUCTIONS
     R7199
```

EXHIBIT CG - B (SCHEDULE B)

```
SCHEDULE B (FORM 1040) INTEREST AND DIVIDEND INCOME            1987  *08
                                                    OMB NO.  1545-0074
JOHN Q. & MARY J. TAXPAYER                                SSN 000-00-0000
******************************************************************************
PART I  INTEREST INCOME
 1.  INTEREST INCOME FROM SELLER FINANCED MORTGAGE                AMOUNT
     NAME OF PAYER                                          1.  00,000.00
 2.  OTHER INTEREST INCOME (LIST)                           2.  00,000.00
     (1st PAYER) (2nd PAYER) (3rd PAYER) (4th PAYER)
 3.  ADD LINES 1 AND 2......................................3.  00,000.00
****************************************************************************
PART II DIVIDEND INCOME
 4.  NAME OF PAYER                                               AMOUNT
     (1st PAYER) (2nd PAYER) (3rd PAYER) (4th PAYER)        4.
 5.  TOTAL OF LINE 4....................................... 5.  00,000.00
 6.  CAPITAL GAIN DISTRIBUTIONS............................ 6.
 7.  NON TAXABLE DISTRIBUTIONS............................. 7.
 8.  ADD LINES 6 and 7 .................................... 8.
 9.  LINE 5 MINUS LINE 8 .................................. 9.  00,000.00
****************************************************************************
PART III - FOREIGN ACCOUNTS AND FOREIGN TRUSTS
10.  DID YOU HAVE AN INTEREST IN OR A SIGNATURE OR OTHER AUTHORITY
     OVER A BANK ACCOUNT, SECURITIES ACCOUNT, OR OTHER FINANCIAL     (ANS)
     ACCOUNT IN A FOREIGN COUNTRY?        COUNTRY NAME
11.  WERE YOU THE GRANTOR OF OR TRANSFEROR TO A FOREIGN TRUST
     WHICH EXISTED DURING THE CURRENT TAX YEAR WHETHER OR NOT
     YOU HAVE ANY BENEFICIAL INTEREST IN IT?                         (ANS)
******************************************************************************


              FOR PAPERWORK REDUCTION ACT NOTICE, SEE SEPARATE INSTRUCTIONS
```

```
EXHIBIT CG - C  (SCHEDULE C) -PAGE 1)

SCHEDULE C       PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION       1987 * 09
(FORM 1040)            (SOLE PROPRIETORSHIP)           OMB NO.  1545-0074
JOHN Q. AND MARY J. TAXPAYER                                SSN 000-00-0000
*****************************************************************************
A.    MAIN BUSINESS ACTIVITY:                          B.  BUSINESS CODE:
C.    NAME AND ADDRESS:                                D.  EMPLOYER ID NO.:  00-0000000

E.    METHOD(S) USED TO VALUE CLOSING INVENTORY:  (1)X COST
F.    ACCOUNTING METH.:  (1)     XX CASH
G.    WAS THERE ANY MAJOR CHANGE IN THE METHOD OF VALUATION?       (YES)  (NO)
H.    DID YOU DEDUCT EXPENSES FOR OFFICE IN HOME?            .     (YES)  (NO)
I.    FORM 941 FILED FOR 1987?                                      (X)    (X)
J.    MATERIALLY PARTICIPATE IN BUSINESS OPN?                       (X)    (X)
K.    BUSINESS IN OPN AT END OF 1987?                               (X)    (X)
L.    MONTH BUSINESS IN OPERATION?                                         (X)
M.    TAX SHELTER LOSS, CREDIT, INCOME, ETC.?                      (YES)  (NO)
*****************************************************************************
PART I - INCOME:
1A.   GROSS RECEIPTS OR SALES ................................1A.    0,000.00.
 B.   RETURNS AND ALLOWANCES..................................1B.
 C.   BALANCE (LINE 1A LESS LINE 1B)..........................1C.    0,000.00
2.    COST OF GOODS SOLD AND/OR OPERATIONS ...................2.
3.    GROSS PROFIT (LINE 1C LESS LINE 2)......................3.     0,000.00
4     OTHER INCOME - SEE STATEMENT XX.........................4
5.    INCOME (ADD LINES 3 & 4)................................5.     0,000.00
*****************************************************************************
PART II-DEDUCTIONS:
6.    ADVERTISING...........0,000,000        23.   REPAIRS...............0,000,000
7.    BAD DEBTS.............                 24.   SUPPLIES (NOT PT III)
      FM SALES OR SERVICES                   25.   TAXES.................
8.    BANK CHARGES.........                  26.   TRAVEL & ENTERTAINMENT
9.    CAR/TRUCK EXPENSES....                 26A.  TRAVEL
10.   COMMISSIONS..........                  26B.  MEALS + ENTERTAINMENT
11.   DEPLETION............                  26C.  20% LN 26B
12.   DEPRECIATION/179 DED..                 26D.  26B LESS 28B
      (NOT PT III).........                  27.   UTILITIES & PHONE.....
13.   DUES AND PUBLICATIONS                  28.   A.  WAGES.............
14.   EMPLOYEE BNFT PROGRAMS                       B. JOBS
15.   FREIGHT (NOT PT III)                         C. 28A LESS 28B.......
16.   INSURANCE............                  29. OTHER EXPENSES (LIST)
17.   INTEREST.............
17A.  MORTGAGE INT. PAID
17B.  OTHER INTEREST........
18.   LAUNDRY AND CLEANING
19.   LEGAL/PROF'L SERVICES
20.   OFFICE EXP...........
21.   PENSION/PROFIT SHARE..
22.   RENT ON BUSINESS PROP 0,000,000      OR SEE STATEMENT XX..0,000,000
*****************************************************************************
30    TOTAL DEDUCTIONS (ADD COLS. 6 THROUGH 29)...............30.    0,000.00
31    NET PROFIT (OR LOSS) (LINE 5 LESS LINE 30)..............31.   0,000.00
32    IF LOSS, DO YOU HAVE AMTS IN THIS BUSINESS NOT AT RISK?       (ANS)
*****************************************************************************
SCHEDULE C CONTINUED ON PAGE 2
FOR PAPERWORK REDUCTION ACT NOTICE, SEE SEPARATE INSTRUCTIONS
```

EXHIBIT CG - C (SCHEDULE C - PAGE 2)

```
SCHEDULE C (CON'T) PG 2
(FORM 1040)                                                       1987 * 09
JOHN Q. + MARY J. TAXPAYER
                                                                  SSN 000-00-0000
PART III COST OF GOODS SOLD AND/OR OPERATIONS
1.  INVENTORY AT BEGINNING OF YEAR (EXPLAIN IF DIFFERENT)..........1. 0,000,000.
2.  PURCHASES (LESS COST OF PERSONAL ITEMS)........................2.
3.  COST OF LABOR (DO NOT INCLUDE OWN SALARY)......................3.
4.  MATERIALS AND SUPPLIES.........................................4.
5.  OTHER COSTS....................................................5.
6.  ADD LINES 1 THROUGH 5..........................................6.
7.  INVENTORY AT END OF YEAR.......................................7.
8.  COST OF GOODS AND/OR OPERATIONS (LN 6 MINUS LN 7)..............8. 0,000,000.
*********************************************************************************
```

EXHIBIT CG - D (SCHEDULE D - PAGE 1)

```
SCHEDULE D                   CAPTIAL GAINS AND LOSSES                1987*12
(FORM 1040)                                                   OMB NO. 1545-0074
JOHN Q. AND MARY J. TAXPAYER                                  SSN 000-00-0000
*******************************************************************************
*************************************************************************
1  REPORT HERE TOTAL SALES OF STOCKS, BONDS, ETC., REPORTED FOR
   1987 BY YOUR BROKER ON FM 1099-B OR EQUIVALENT STATEMENT.      1.  0,000,000.
*******************************************************************************
*****************PART I - SHORT-TERM CAPITAL GAINS AND LOSSES*******************
    (A)         (B)       (C)      (D)          (E)        (F)          (G)
   KIND OF      DATE      DATE     GROSS        COST OR    LOSS: (E)    GAIN: (D)
   PROPERTY     ACQ.      SOLD     SALE PRICE   BASIS      LESS  (D)    LESS  (E)
2A FORM 1099-B TRANSACTIONS
2B TOTAL (COL. (D))
2C OTHER TRANSACTIONS
(1ST)           M/D/Y    M/D/Y    0,000,000.   0,000,000.  0,000,000      0,000,000.
(2ND)
(3RD)                OR SEE STATEMENT XX
---------------------------------------------------------------------------------
3   GAIN FROM SALE/EXC RES. (FM 2119)           3.XXXXXXXXXXXXXXXXX       0,000,000.
4   SHORT-TERM CAP GAIN (FROM FM 6252)          4.XXXXXXXXXXXXXXXXX
5   NET S-TERM GAIN PARTN/SCORP/FIDUC............5.      0,000,000.       0,000,000.
6   SHORT TERM LOSS CARRYOVER .......           6..................... XXXXXXXXXXXXX
7   ADD LINES 2A, 2C, & 3 THRU 6 COL (F)&(G).....7.....................
8   NET ST GAIN OR LOSS ADD COL. (F) + (G) LN 7.......................8.   0,000,000
    ***************** PART II - LONG-TERM CAPITAL GAINS AND LOSSES*******************
9A FORM 1099-B TRANSACTIONS
   (1st)         M/D/Y   M/D/Y    0,000,000.   0,000,000.  0,000,000      0,000,000.
   (2nd)
   (3rd)
9B  TOTAL (COL. (D))
9C  OTHER TRANSACTIONS
                     OR SEE STATEMENT XX
10  GAIN FROM SALE/EXC RES.  (FM 2119          10.XXXXXXXXXXXXXXXXXXXX    0,000,000.
11  LONG-TERM GAIN - INSTALL. SALES (F6252)     11.XXXXXXXXXXXXXXXXXXXX
12  NET L-TERM GAIN/LOSS PARTN/SCORP/FIDUC      12.          0,000,000    0,000,000.
13  CAPITAL GAIN DISTRIBUTIONS.................. 13.XXXXXXXXXXXXXXXXXXXX
14  GAIN FROM FORM 4797......................... 14.XXXXXXXXXXXXXXXXXXXX
15  L-TERM CAPITAL LOSS CARRYOVER .............. 15.          0,000,000 XXXXXXXXXXXXX
16  TOTAL LINES 9A, 9C, + 10 THRU 15 IN COL. (F)+(G)..................16.
17  NET L-TERM GAIN OR (LOSS), ADD COL. (F)+(G) LN 16.................17.   0,000,000

                        SCHEDULE D CONTINUED ON PAGE 2

                FOR PAPERWORK REDUCTION ACT NOTICE, SEE SEPARATE INSTRUCTIONS
```

EXHIBIT CG - D (SCHEDULE D - PAGE 2)

```
SCHEDULE D (CON'T)  PG 2                                              1987 * 12
(FORM 1040)
JOHN Q. & MARY J. TAXPAYER                                         SSN 000-00-0000
*******************  PART III    SUMMARY OF PARTS I & II ***************************
18  ADD LINES 8 & 17......................................................18.
19. IF LINE 18 LOSS, ENTER SMALLER OF:....................................19.
    (A)  LINE 18,
    (B)  $3,000 ($1500 IF MFS)
**********************************************************************************
PART IV ALTERNATIVE TAX COMPUTATION
20 ENTER FORM 1040, LINE 36...............................................20.
21 ENTER SMALLEST GAIN FROM LINES 17 or 18................................21.
22 SUBTRACT LINE 21 FROM LINE 20..........................................22.
23 ENTER $16,800, $28,000, $14,000, or $23,000............................23.
24 ENTER LARGER OF LINE 22 OR LINE 23.....................................24.
25 SUBTRACT LINE 24 FROM LINE 20..........................................25.
26 FIGURE LINE 24 TAX.....................................................26.
27 MULTIPLY LINE 25 BY 28% (.28)..........................................27.
28 ADD LINES 26 AND 27....................................................28.
***********************************************************************************
PART V COMPUTATION OF CAPITAL LOSS CARRYOVERS (87 to 88)
29  ENTER LOSS SHOWN ON LINE 8; IF NONE, ENTER ZERO.......................29.
30  ENTER GAIN SHOWN ON LINE 17...........................................30.
31  SUBTRACT LINE 30 FROM LINE 29.. ......................................31.
32  ENTER SMALLER OF LINE 19 OR LINE 31...................................32.
33  SUBTRACT LINE 32 FROM LINE 31.........................................33
34  ENTER LOSS FROM LINE 17;..............................................34.
35  ENTER GAIN SHOWN ON LINE 8............................................35.
36  SUBTRACT LINE 35 FROM LINE 34.........................................36.
37  SUBTRACT LINE 32 FROM LINE 19.........................................37.
38  SUBTRACT LINE 37 FROM LINE 36.........................................38.
**********************************************************************************
PART VI COMPLETE IF YOU ELECT OUT OF THE INSTALLMENT METHOD AND ARE REPORTING A NOTE,
  ETC., AT LESS THAN FACE VALUE
__________________________________________________________________________________.
39  CHECK IF ELECTED                                                         (ANS)
40  ENTER FACE AMOUNT OF NOTE...................................0,000,000.
41  ENTER THE PERCENTAGE OF VALUATION OF NOTE.........................XX%.
**********************************************************************************
PART VII RECONCILIATION OF FORMS 1099-B
42  FORM 1040, LINE 21....................................................42.
43  SCHEDULE C............................................................43.
44  SCHEDULE D............................................................44.
45  SCHEDULE E............................................................45.
46  SCHEDULE F............................................................46.
47  OTHER (LIST)..........................................................47.
48  TOTAL OF LINES 42 THRU 47.............................................48.
```

EXHIBIT CG - E (SCHEDULE E - PAGE 1)

```
CHEDULE E          SUPPLEMENTAL INCOME SCHEDULE                     1987 * 13
(FORM 1040)                                             OMB NO.  1545 - 0074
JOHN Q. AND MARY J. TAXPAYER                                SSN  000-00-0000
******************  PART I - RENT & ROYALTY INCOME/LOSS *********************
****************************************************************************
1.  SHOW KIND + :  2.  WAS PROPERTY USED BY :      3.  ACTIVELY PARTICIPATE IN
    LOCATION OF :      YOU OR FAMILY MORE THAN 14:     OPERATION OF ACTIVITY
    RENTAL PROP.:      DAYS OR S10% OF DAYS RENTED?:   DURING THE TAX YEAR?
    PROPERTY A_ _ _ _ _ _ _ _ _ _ _ _ _ _ _ _ (ANS)                  (ANS)
    PROPERTY B_ _ _ _ _ _ _ _ _ _ _ _ _ _ _ _ (ANS)                  (ANS)
    PROPERTY C_ _ _ _ _ _ _ _ _ _ _ _ _ _ _ _ (ANS)                  (ANS)
****************************************************************************
RENTAL AND ROYALTY INCOME                    : PROPERTIES              TOTALS
                                    A            B            C

4.   A RENTS RECEIVED            :00,000.  :00,000.     : 00,000. :4.  00,000,000.
5.   B ROYALTIES RECEIVED        :00,000.  :            :         5.
****************************************************************************
RENTAL AND ROYALTY EXPEN.           :          :            :     :XXXXXXXXXXXXXXXXX
6    ADVERTISING                  6.:          :            :     :XXXXXXXXXXXXXXXXX
7    AUTO AND TRAVEL              7.:          :            :     :XXXXXXXXXXXXXXXXX
8    CLEANING AND MAINTENANCE     8.:          :            :     :XXXXXXXXXXXXXXXXX
9    COMMISSIONS                  9.:          :            :     :XXXXXXXXXXXXXXXXX
10   INSURANCE                   10.:          :            :     :XXXXXXXXXXXXXXXXX
11   LEGAL PROF FEES             11.:          :            :     :XXXXXXXXXXXXXXXXX
12   MORTAGAGE INTEREST PAID     12.:          :            :     :12.
13   OTHER INTEREST PAID         13.:          :            :     :XXXXXXXXXXXXXXXXX
14   REPAIRS                     14.:          :            :     :XXXXXXXXXXXXXXXXX
15   SUPPLIES                    15.:          :            :     :XXXXXXXXXXXXXXXXX
16   TAXES NOT WINDFALL          16.:          :            :     :XXXXXXXXXXXXXXXXX
17   UTILITIES                   17.:          :            :     :XXXXXXXXXXXXXXXXX
18   WAGES AND SALARIES          18.:          :            :     :XXXXXXXXXXXXXXXXX
19.  OTHER (LIST)                19.:          :            :     :XXXXXXXXXXXXXXXXX
     (1ST)                          :          :            :     :XXXXXXXXXXXXXXXXX
     (2ND)                          :          :            :     :XXXXXXXXXXXXXXXXX
     (3RD)                          :          :            :     :XXXXXXXXXXXXXXXXX
     (4TH) OR SEE STATEMENT         :          :            :     :XXXXXXXXXXXXXXXXX
****************************************************************************
20   TOTAL EXPENSES              20.                               20.
21   DEPRECIATION EXPENSE        21.                               21.
22.  TOTAL (ADD LINES 20 & 21)   22.                               22.  XXXXXXXXXXXXXXXXX
23.  INCOME OR (LOSS)            23.                               23.  XXXXXXXXXXXXXXXXX
24.  DED. RENTAL LOSS                                              24.  XXXXXXXXXXXXXXXXX
25.  ADD LN 23 PROFITS.                                            25.
26.  ADD LN 23 + 24 LOSSES                                         26.
27.  COMBINE LNS 25/26                                             27.
28.  NET FARM PROFIT/LOSS (FORM 4835)                              28.
29.  TOTAL RENT/ROYALTY INC. (ADD LINES 27 + 28)                   29.

     SCHEDULE E CONTINUED ON PAGE 2

             FOR PAPERWORK REDUCTION ACT NOTICE, SEE SEPARATE INSTRUCTIONS
```

EXHIBIT CG - E (SCHEDULE E - PAGE 2)

```
SCHEDULE E (CONT'D) PAGE 2                                      1987*13
(FORM 1040)                                                     SSN 000-00-0000
JOHN Q. & MARY J. TAXPAYER

***PART II  INCOME OR LOSS FROM PARTNERSHIPS AND S. CORP.**************

(A) NAME        (B) CODE      (C)FOREIGN      (D)EIN       (E) NOT AT RISK
                                  (X)                           (ANS)
   (INSERT INFO HERE AS NEEDED OR SEE STATEMENT X)
     PASSIVE ACTIVITIES                 NONPASSIVE ACTIVITIES
 (F) FORM 8582    (G) SCH. K-1     (H) SCH .K-1     (I) SEC. 179      (J) SCH. K-1
     LOSS             INCOME           LOSS             DED.              INCOME
     0,000,000.      0,000,000.      0,000,000        0,000,000.       0,000,000.
     (INSERT INFO HERE AS NEEDED, OR SEE STATEMENT X)
30A. TOTALS
  B. TOTALS
31. ADD AMOUNTS IN COLUMNS (G) AND (J) LINE 30A                    31.
32. COMBINE AMOUNTS IN (F),(H),AND (I) LINE 30B                    32.
33  TOTAL PARTNERSHIP & S CORP. INCOME LINES 31 and 32             33.
****PART III INCOME OR LOSS FROM ESTATES AND TRUSTS*******************
       (A) NAME                                (B) EIN
     (INSERT INFO HERE AS NEEDED, OR SEE STATEMENT X)
           PASSIVE ACTIVITIES               NONPASSIVE ACTIVITIES
       (C) FORM 8582     (D) SCH. K-1      (E) SCH. K-1       (F) SCH. K-1
           DED/LOSS          INCOME            DED/LOSS           INCOME
34A.  TOTALS
  B.  TOTALS
35.  ADD AMOUNTS IN COLUMNS (D) AND (F), LINE 34A                  35.
36.  ADD AMOUNTS IN COLUMNS (C) AND (E), LINE 34B                  36.
37.  TOTAL ESTATE AND TRUST INCOME (LOSS)                          37.
*** PART IV INCOME OR LOSS FROM REMIES ********************************
  (A) NAME    (B) EIN    (C) SCH. Q INCL.    (D) SCH. Q INC.    (E) SCH.Q INC.
                             LN. 2C              LN. 1B             LN. 3B
38. COMBINE COLUMNS (D) AND (E)                                    38.
*******************     PART V WINDFALL PROFIT TAX SUMMARY     ********************
39. WINDFALL PROFIT TAX CREDIT OR REFUND IN 1987                   39.
40. WINDFALL PROFIT TAX WITHELD IN 1987                            40.
41. COMBINE AMOUNTS ON LINES 39 AND 40                             41.
****************************     PART VI SUMMARY     ******************************


42. TOTAL INCOME OR (LOSS)                                         42.
43. FARMING AND FISHING INCOME                                     43.
```

```
EXHIBIT CG - F (SCHEDULE F - PAGE 1)

   SCHEDULE F                    FARM INCOME AND EXPENSES                    1987 * 14
(FORM 1040)                                                    OMB NO.  1545-0074
JOHN Q. & MARY J. TAXPAYER                                          SSN  000-00-0000
A PRINCIPAL PRODUCT:                                 B AGRICULTURAL ACTIVITY CODE:
C ACCOUNTING METHOD:     CASH ( )        ACCRUAL (X)           D  EIN  00-0000000
E PRIOR YR COMMODITY CR LOAN INCOME ELECTION?                  (YES)          (NO)
F MATERIALLY PARTICIPATE IN OPN OF BUS IN 1987?                (YES)          (NO)
G ELECT NOT TO CAPITALIZE REPRO PD EXPENSE                     (YES)          (NO)
**********PART I - FARM INCOME - CASH METHOD*************************************
 1  SALES OF LIVESTOCK AND ITEMS FOR RESALE                   1. 0,000,000.
 2  COST OR BASIS OF LIVESTOCK FOR RESALE                     2.
 3  SUBTRACT LN 2 FM LN 1                                     3.
 4  SALES OF LIVESTOCK & PRODUCTS RAISED                      4.
 5A TOTAL DISTRIBUTIONS FM COOPERATIVES (FM 1099-PATR)        5A.
 5B LESS: NONINCOME ITEMS                                     5B.
 6  NET DISTRIBUTIONS (LN 5A MINUS LN 5B)                     6.
 7A AGRICULTURAL PROG PAYMENTS - CASH                         7A.
 7B AGRICULTURAL PROG PAYMENTS - MATERIAL & SVCS              7B.
 8  COMMODITY CREDIT LOANS                                    8.
 9  CROP INSURANCE PROCEEDS         INC. ELECTION?  ( )       9.
 10 MACHINE WORK                                              10.
 11 OTHER INCOME                                              11.
 12 GROSS INCOME (LN 3,4,6, & 7A thru 11, OR PART III, LN 52)  12. 0,000,000.
**********PART II - FARM DEDUCTIONS - CASH & ACCRUALMETHOD************************
 13 BREEDING FEES          0,000,000.   24A LABOR HIRED                  0,000,000.
 14 CHEMICALS                             B JOBS CREDIT
 15 CONSERVATION EXPENSES                 C NET LABOR
    ATTACH FM 8645                          (LN 24A MINUS LN 24B)
 16 DEPRECIATION & SEC 179              25 MACHINE HIRE
    EXPENSE DEDUCTION                   26 PENSION/PROFIT SHARING
 17 EMPLOYEE BENEFIT PROG               27 RENT OF FARM, PASTURE
    OTHER THAN LINE 26                  28 REPAIRS, MAINTENANCE
 18 FEED PURCHASED                      29 SEEDS, PLANTS PURCHASED
 19 FERTILIZERS AND LIME                30 STORAGE, WAREHOUSING
 20 FREIGHT, TRUCKING                   31 SUPPLIES PURCHASED
 21 GASOLINE, FUEL, OIL                 32 TAXES
 22 INSURANCE                           33 UTILITIES
 23 INTEREST:                           34 VET FEES, MEDICINE
    A MORTGAGE INT PAID                 35 OTHER EXPENSES (SPECIFY)
      TO FIN INST                       A_______________________
    B OTHER INTEREST      0,000,000.    B_______________________
                                                                     0,000,000.

**********************************************************************************

 36 TOTAL DEDUCTIONS FM PT II (ADD LN 13 THRU 35)            36.
 37 NET FARM PROFIT/LOSS (LN 12 LESS LN 36)                  37.
 38 IF LOSS, DO YOU HAVE AMTS FOR FARM THAT ARE NOT "AT RISK?"     (ANS)

                     SCHEDULE F CONTINUED ON PAGE 2




               FOR PAPERWORK REDUCITON ACT NOTICE, SEE SEPARATE INSTRUCTIONS
```

EXHIBIT CG - F   (SCHEDULE F - PAGE 2)

```
SCHEDULE F (CON'T)          PAGE 2                      1987 *14
JOHN Q. & MARY J. TAXPAYER                          SSN  000-00-0000
********************** PART III - FARM INCOME - ACCURAL METHOD *****************
39  SALES OF LIVESTOCK & PRODUCTS DURING YEAR              39.  0,000,000.
40A TOTAL COOPERATIVE DISTRIBUTIONS                        40A.
40B LESS NONINCOME ITEM                                    40B.
41  NET DISTRIBUTIONS (LN 40A MINUS 40B)                   41.
42A AGRICULTUAL PROG PAYMENTS - CASH                       42A.
42B AGRICULTUAL PROG PAYMENTS - MATERIAL & SVCS            42B.
43  COMMODITY CREDIT LOANS                                 43.
44  MACHINE WORK                                           44.
45  OTHER INCOME                                           45.
46  TOTAL (ADD LN 39 and 41 THRU 45)                       46
47  INVENTORY OF LIVESTOCK & PROD BEGIN OF YEAR            47.
48  COST OF LIVESTOCK & PROD PURCHASE DURING YEAR          48.
49  ADD LN 47 & 48                                         49
50  INVENTORY OF LIVESTOCK & PROD END OF YEAR              50.
51  COST OF LIVESTOCK & PROD SOLD (LN 49 MINUS LN 50)      51.
52  GROSS INCOME (LN 46 MINUS LN 51)                       52.
    ENTER ALSO ON PART I, LN 12
**********************************************************************************
```

EXHIBIT CG-R (SCHEDULE R-PAGE 1)

SCHEDULE R CREDIT FOR THE ELDERLY AND DISABLED 1987*17
(FORM 1040) OMB NO. 1545-0074
JOHN Q. AND MARY J. TAXPAYER SSN 000-00-0000

****

PART I - FILING STATUS AND AGE

STATUS (END OF 1987)		CHECK ONLY ONE ANSWER:
SINGLE	1 65 OR OVER	1. (X)
	2 UNDER 65, RETIRED ON DISABILITY	2. ( )
MARRIED	3 BOTH 65 OR OVER	3. ( )
FILING	4 BOTH UNDER 65, ONE DISABILITY RET	4. ( )
JOINTLY	5 BOTH UNDER 65, BOTH DISABILITY RET	5. ( )
	6 ONE 65, ONE UNDER 65 ON DIS RET	6. ( )
	7 ONE 65, ONE UNDER 65 NOT DIS RET	7. ( )
MARRIED	8 65 AND DID NOT LIVE W/SPOUSE IN 1987	8. ( )
FILING SEP	9 UNDER 65, DIS RET & NOT LIVE W/SPOUSE	9. ( )

**************************PART II - STATEMENT OF PERMANENT AND TOTAL DISABILITY********

CHECK IF STATEMENT FILED IN 1983 OR EARLIER, OR AFTER 1983 WITH BOX B CHECKED BY PHYSICIAN, AND YOU WERE UNABLE TO WORK IN 1987. ( )

PHYSICIAN'S STATEMENT

I CERTIFY THAT ______________________________
NAME OF DISABLED PERSON

WAS PERMANENTLY AND TOTALLY DISABLED ON JANUARY 1, 1976, OR JANUARY 1, 1977, OR WAS PERMANENTLY AND TOTALLY DISABLED ON THE DATE HE OR SHE RETIRED. DATE RETIRED IF RETIRED AFTER DECEMBER 31, 1976:______________________________

PHYSICIAN: SIGN YOUR NAME ON EITHER LINE A OR B BELOW & CHECK THE BOX.

A. DISABILITY HAS LASTED, OR CAN BE EXPECTED TO LAST CONTINUOUSLY FOR AT LEAST A YEAR. ______________________________
PHYSICIANS SIGNATURE DATE A.( )

B. THERE IS NO REASONABLE PROBABILITY THAT THE DISABLED CONDITION WILL EVER IMPROVE. ______________________________
PHYSICIANS SIGNATURE DATE B.( )

PHYSICIAN'S NAME: PHYSICIAN'S ADDRESS:

****

FOR PAPERWORK REDUCTION ACT NOTICE, SEE SEPARATE INSTRUCTIONS

EXHIBIT CG-R (SCHEDULE R - PAGE 2)

```
SCHEDULE R (CON'T) PAGE 2                                        1987
(FORM 1040)
JOHN Q. & MARY J. TAXPAYER                          SSN  000-00-0000
********************************************************************
PART III - FIGURE CREDIT
10. ENTER $5,000, $7,500 OR $3,750                               10.   00,000.00
11. TAXABLE DISABILITY INCOME                                    11.
12. ENTER SMALLER AMOUNT FROM LINE 10 OR LINE 11                 12.
13A.NON-TAXABLE SOCIAL SECURITY BENEFIT                          13A.
13B.NON-TAXABLE RAILROAD RETIREMENT BENEFITS, ETC                13B.
13C ADD LINES 13A AND 13B, OR ZERO                               13C.
14. ENTER AMOUNT FROM FORM 1040, LN 31                           14.
15. ENTER $7,500, $10,000 OR $5,000                              15.
16. SUBTRACT LINE 15 FROM LINE 14, OR ZERO                       16.
17. DIVIDE LINE 16 BY 2                                          17.
18. ENTER TOTAL OF LINE 13C AND LINE 17                          18.
19. SUBTRACT LINE 18 FROM LINE 12                                19.
20. PERCENTAGE USED TO FIGURE CREDIT                             20.       X.15
21. MULTIPLY LINE 19 BY 15$ (.15)                                21.
(ENTER THIS AMOUNT ON FORM 1040, LINE 41)
```

EXHIBIT CG - SE (SCHEDULE SE)

1987* 18

SCHEDULE SE
COMPUTATION OF SOCIAL SECURITY SELF-EMPLOYMENT TAX
OMB NO. 1545-0074
(FORM 1040)
SSN 000-00-0000
JOHN Q AND MARY J. TAXPAYER

****

A IF SE EARNINGS ONLY AS MISISTER, RELIGIOUS ORDER MEMBERS, OR CHRISTIAN SCIENCE PRACTITIONER, + FORM 4361 FILED, DO NOT FILE SCH. SE. WRITE "EMEMPT FORM 4361" ON FORM 1040, LINE 48. IF FORM 4361 FILED, BUT YOU HAVE $400 OF OTHER SE EARNINGS, CONTINUE WITH PART I + CHECK HERE ( )

B IF FORM 4029 FILED + IRS APPROVED, DO NOT FILE SCH. SE. WRITE "EXEMPT FORM 4029" ON FORM 1040, LINE 48.

C IF SE EARNINGS ONLY FROM AN EXEMPT CHURCH OR CHURCH ORGANIZATION + NOT A MINISTER OR RELIGIOUS ORDER MEMBER, SKIP TO LINE 9 + ENTER ZERO. CONTINUE WITH LINE 11A.

****

PART I - REGULAR COMPUTATION OF NET EARNINGS FROM SELF EMPLOYMENT

1 NET PROFIT OR (LOSS) FROM SCHEDULE F, LN. 37, AND FARM PARTNERSHIPS, SCHEDULE K-1 (1065), LN.14A ....1.

2 NET PROFIT OR (LOSS) FROM SCHEDULE C, LN. 31, AND SCHEDULE K-1(FORM 1065), LN. 14A ....2.

****

PART II - OPTIONAL COMPUTATION OF NET EARNINGS FROM SELF EMPLOYMENT

3 MAXIMUM INCOME FOR OPTIONAL METHOD............................3. 1,600.00

4 FARM OPTIONAL METHOD -2/3 RDS OF GROSS INCOME FROM SCH. F, LN. 12 AND FARM PARTNERSHIPS, SCH. K-1, (1065), LN. 14B, OR $1,600, WHICHEVER IS SMALLER..4.

5 SUBTRACT LINE 4 FROM LINE 3.................................... 5.

6 NONFARM OPTIONAL METHOD - SMALLER, 2/3 RDS GROSS INCOME FROM SCH. C, LN. 5, AND SCH. K-1, (1065) LINE 14C (OTHER THAN FARMING), $1,600, OR, IF YOU ELECTED FARM OPTIONAL METHOD, AMOUNT ON LINE 5.. 6.

****

PART III - COMPUTATION OF SOCIAL SECURITY SELF EMPLOYMENT TAX

7 AMOUNT FROM PART I, LINE 1, OR, PART II, LINE 4.............7.
8 AMOUNT FROM PART I, LINE 2, OR, PART II, LINE 6.............8.
9 ADD LINES 7 AND 8...9.
10 LARGEST AMOUNT SUBJECT TO SOCIAL SECURITY OR RRTA TAX......10. 43,800.00
11A TOTAL SOC. SEC. WAGES FROM W-2 AND RRTA COMPENSATION.......11A.
11B UNREPORTED TIPS SUBJECT TO SS (FORM 4137) OR RRTA..........11B.
11C ADD LINES 11A AND 11B...................................... 11C.
12A SUBTRACT LINE 11C FROM LINE 10............................12A
12B MEDICARE QUALIFIED GOVT WAGES........................ 12B.
12C FORM W-2 ELECTING CHURCH & ORG WAGES.......................12C.
12D ADD LINES 9 AND 12C..12D.
13 SMALLER OF LINE 12A OR 12D.................................13.
14 SELF EMPLOYMENT TAX - ENTER ON FORM 1040, LINE 48........14.

FOR PAPERWORK REDUCTION ACT NOTICE, SEE SEPARATE INSTRUCTIONS

```
EXHIBIT CG-3903               (FORM 3903)                              1987 *62
FORM 3903                     MOVING EXPENSES
                                                              OMB NO. 1545-0062
                                                               SSN 000-00-0000
JOHN Q. & MARY J. TAXPAYER
*******************************************************************************
1. MILES FM OLD RESIDENCE TO NEW WORK PLACE                1.  0,000
2. MILES FM OLD RESIDENCE TO OLD WORK PLACE                2.
3. LINE 1 MINUS LINE 2                                     3.
*******************************************************************************
SECTION A.  TRANSPORTATION OF HOUSEHOLD GOODS
  4.  ACTUAL COST OF MOVING HOUSEHOLD GOODS                               4. 00,000.00
*******************************************************************************
SECTION B.  TRVL EXPENSES FM OLD TO NEW RES.
  5.  TRAVEL + LODGING MINUS MEALS                                        5.  0,000.00
  6.  TOTAL MEALS                                                         6.
  7.  MEAL REIMB. RCVD (LN 6) WITH NO INCOME TAX WITHHELD                 7.
  8.  LINE 6 MINUS LINE 7                                                 8.
  9.  MULTIPLY LINE 8 BY 80%                                              9.
 10.  ADD LINES 5, 7, and 9
*******************************************************************************
SECTION C. PRE-MOVE EXPENSE LOOKING FOR NEW RES.
 11.  TRAVEL + LODGING MINUS MEALS                                        11.
 12.  TOTAL MEALS (HOUSE HUNTING)                                         12.
 13.  MEAL REIMB. RCVD (LN 12) WITH NO INCOME TAX WITHHELD                13.
 14.  LINE 12 MINUS LINE 13                                               14.
 15.  MULTIPLY LINE 14 BY 80%                                             15.
 16.  ADD LINE 11, 13, AND 15                                             16.
*******************************************************************************
SECTION D.  TEMP. LIVING EXPENSE (ANY CONSECUTIVE 30 DAYS AFTER GETTING JOB)
 17.  LODGING EXP. MINUS MEALS                                            17.
 18.  TOTAL MEALS (TEMP. QUARTERS)                                        18.
 19.  MEAL REIMB. RCVD (LN 18) WITH NO INCOME TAX WITHHELD                19.
 20.  LINE 18 MINUS LINE 19                                               20.
 21.  MULTIPLY LINE 20 BY 80%                                             21.
 22.  ADD LINES 17, 19, AND 21                                            22.
*******************************************************************************
SECTION E. QUALIFIED REAL ESTATE EXPENSE.
 23.  EXPENSES OF:
      A. (X) SELLING OR EXCHANGING OLD RESIDENCE
      B. ( ) SETTLING UNEXPIRED RENTAL LEASE                              23.
 24.  EXPENSES OF:
      A. (X) BUYING A NEW RESIDENCE
      B. ( ) GETTING NEW RENTAL LEASE                                     24.
*******************************************************************************
SECTION F. DOLLAR LIMITATIONS.
 25.  ADD LINES 16 AND 22.                                                25.
 26.  ENTER SMALLER OF LN 25 OR $1500 (OR $750)                           26.
 27.  ADD LINES 23, 24, AND 26                                            27.  0,000.00
 28.  ENTER SMALLER OF LN 27 OR $3000 (OR $1500)                          28.
 29.  ADD LINES 4, 10, AND 28
      MOVING EXPENSE DEDUCTION (ENTER ON SCH. A, LN 19)                   29.  0,000.00
*******************************************************************************
      FOR PAPERWORK REDUCTION ACT NOTICE, SEE SEPERATE INSTRUCTIONS
```

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 88-8

SECTION 1. PURPOSE

The purpose of this revenue procedure is to implement section 10511 of the Revenue Act of 1987, Public Law 100-203, enacted December 22, 1987, which requires the payment of user fees for requests to the Internal Revenue Service for rulings, opinion letters, determination letters, and similar requests.

SEC. 2. BACKGROUND

.01 Section 10511 of the Act provides that the Secretary of the Treasury or his delegate (referred to this revenue procedure as the "Secretary") shall establish a program requiring the payment of user fees for requests to the Service for rulings, opinion letters, determination letters, and similar requests. Section 10511 provides that such fees shall apply with respect to requests made on or after the 1st day of the second calendar month beginning after the date of enactment and before September 30, 1990. The fees charged under the program are to vary according to categories (or subcategories) established by the Secretary; they are to be determined after taking into account the average time for, and difficulty of, complying with requests in each category and subcategory; and they are to be payable in advance. The Secretary is to provide for such exemptions and reduced fees under the program as he determines to be appropriate, but the average fee applicable to each category must not be less than the amount specified in the statute.

.02 In order to provide rapid guidance to the public, a revenue procedure has been issued instead of a regulation. However, the Service is providing an opportunity to submit written comments on this revenue procedure. Comments should be sent to: Assistant Commissioner (EP/EO), Attn: E:EP:P, 1111 Constitution Ave., N.W., Washington, D.C. 20224. If the comments reflect a need, a public meeting will be scheduled to discuss suggested changes. This revenue procedure, and any changes made in response to public comments, will then be incorporated in the Statement of Procedural Rules.

SEC. 3. EXISTING PROCEDURES

.01 Rev. Proc. 88-1, page 557, this Bulletin, provides, other than for international issues, procedures for issuing rulings and information letters and for entering into closing agreements on specific issues involving the interpretation or application of the federal tax laws under the jurisdiction of the Associate Chief Counsel (Technical and International). It also provides, other than for international issues, procedures for issuing determination letters on matters that relate to sections of the Code under the jurisdiction of the Associate Chief Counsel (Technical and International).

.02 Concerning international issues, Rev. Proc. 87-4, 1987-1 C.B. 529, provides procedures for obtaining rulings, closing agreements, and information letters on federal tax issues under the jurisdiction of the Associate Chief Counsel (Technical and International) and provides information concerning determination letters under the jurisdiction of the Assistant Commissioner (International) and the District Directors.

.03 Rev. Proc. 80-30, 1980-1 C.B. 685, sets forth the general procedures of the various offices of the Service pertaining to the issuance of determination letters on the qualification of pension, profit-sharing and stock bonus plans involving sections 401, 403(a), 409 and 4975(e)(7) of the Code, and the status for exemption of any related trusts or custodial accounts under section 501(a).

.04 Rev. Proc. 83-36, 1983-1 C.B. 763, as modified by Rev. Proc. 87-40 1987-2 C.B. 514, sets forth the general procedures of the Service in issuing rulings, determination, opinion, notification, and information letters to taxpayers and in entering into closing agreements on specific issues as to the interpretation or application of the federal tax laws in the employee plan and exempt organization areas.

.05 Rev. Proc. 84-23, 1984-1 C.B. 457, sets forth the procedures of the Service pertaining to the issuance of opinion letters relating to master or prototype pension, annuity, and profit-sharing plans involving sections 401 and 403(a) of the Code, as amended by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and the status for exemption of related trusts or custodial accounts under section 501(a).

.06 Rev. Proc. 84-46, 1984-1 C.B. 541, provides procedures for applications for recognition of exemption from federal income tax under sections 501 and 521 of the Code.

.07 Rev. Proc. 84-86, 1984-2 C.B. 787, sets forth the procedures of the Service for issuing notification and determination letters relating to the qualification of certain defined contribution and defined benefit plans and any related trusts or custodial accounts under sections 401, 403(a), and 501(a) of the Code, as amended by TEFRA, the Tax Reform Act of 1984 (TRA '84), and the Retirement Equity Act of 1984 (REA). Rev. Proc. 84-86 establishes a means whereby certain "sponsors" may submit "uniform plans" to key district directors for approval as to form.

.08 Rev. Proc. 87-50, 1987-2 C.B. 647, updates and consolidates in one revenue procedure the procedures of the Service relating to the issuance of rulings and opinion letters with respect to the establishment of individual retirement accounts and annuities (IRAs) under section 408 of the Code, the entitlement to exemption of related trusts or custodial accounts under section 408(e), and the acceptability of the form of prototype simplified employee pension (SEP) agreements under sections 408(k) and 415.

SEC. 4. USER FEES

.01 *Applicability*. Except as provided in section 4.09 below, all requests for rulings, determination letters or opinion letters submitted on or after the effective date of this revenue procedure and before September 30, 1990, by or on behalf of taxpayers, sponsoring organizations, or other entities must be accompanied by the appropriate user fee as determined from the schedule set forth in section 4.03 below. Except as provided in section 4.09, user fees apply to all requests for reconsideration of rulings, determination letters, or opinion letters, but may be refunded in certain situations (see section 4.082 below). User fees do not apply to requests for information letters.

.02 *Definitions*. The terms "ruling," "determination letter," "opinion letter," "notification letter," "information letter," "master plan," "prototype plan," "sponsoring organization," "mass submitter," "basic plan document," "adoption agreement," and "uniform plan," as used in this revenue procedure have the same meaning as they have in the pertinent revenue procedure referred to in section 3 above.

.03 *Fee Schedule*. The amount of the user fee payable with respect to each category or subcategory of submission is as set forth in the following schedule:

1. *Associate Chief Counsel (Technical and International) Rulings*	
Application with respect to accounting periods (Form 1128 and 2553)	$ 150
Change in accounting method (Form 3115)	$ 200
Earnings and profits determinations (Form 5452)	$ 200
All other rulings (which includes accounting period, accounting method, and earnings and profits requests other than those submitted on Forms 1128, 3115 and 5452)	$ 300
2. *Employee Plan Rulings and Opinion Letters*	
(a) *Rulings*	
Computation of exclusion for annuitant under section 72	$ 50
Change in plan year (Form 5308)	$ 150
Change in funding method	$ 200
Requests for approval to become a nonbank trustee (see section 1.401-12(n) of the Income Tax Regulations)	$1,000
Waiver of minimum funding ($1,000,000 and over)	$1,000
Waiver of minimum funding (under $1,000,000)	$ 750
All other rulings	$ 400
(b) *Opinion Letters on Master and Prototype Plans**	
Mass submission, per basic plan document (new or amended, regardless of number of adoption agreements)	$1,000
Sponsoring organization's identical adoption of mass submitter's basic plan document, per adoption agreement (mass submitters who are sponsoring organizations in their own right are liable for this fee)	$ 100
Sponsoring organization's minor modifications of mass submitter's plan document, per adoption agreement	$ 400
Non-mass submission by sponsoring organization, per adoption agreement	$1,000
Sponsoring organization's adoption of model section 401(k) amendment, per adoption agreement	$ 100
(c) *Opinion Letters on Prototype Individual Retirement Accounts/Annuities and Simplified Employee Plans**	
Mass submission, per plan document, new or amended	$1,000
Sponsoring organization's identical adoption of mass submitter's prototype IRA or SEP, per plan document	$ 100
Sponsoring organization's minor modification of mass submitter's prototype IRA or SEP, per plan document	$ 400
Non-mass submission by sponsoring organization, per plan document	$1,000
*The terms "mass submitter," "identical adoption," and "minor modification" are explained in section 17 of Rev. Proc. 84-23 (relating to master and prototype plans) and in section 7 of Rev. Proc. 87-50 (relating to IRAs and SEPs).	
3. *Exempt Organization Rulings*	
Change in accounting period (Form 1128)	$ 150
Change in accounting method (Form 3115)	$ 200
All other rulings	$ 400
4. *Employee Plan Determination and Notification Letters*	
Defined benefit and defined contribution plans (Forms 5300 and 5301):	
Under 100 participants	$ 400
100 or more participants	$ 600
Collectively bargained plans (Form 5303)	$ 500
Adopters of master and prototype plans, uniform plans, or other pre-approved plans as designated by the Assistant Commissioner (Employee Plans and Exempt Organizations) (Form 5307).	$ 100
Terminating plans (Form 5310):	
Under 100 participants	$ 200
100 or more participants	$ 350
Short amendments (Form 6406)	$ 100
Uniform plans (Form 4461)	$ 500
Group trusts	$ 400

5. *Exempt Organization Determination Letters*	
Initial application for exemption under section 501 from organizations (other than pension, profit-sharing, and stock bonus plans described in section 401) that have had annual gross receipts averaging not more than $5,000 during the preceding four years, or new organizations which anticipate gross receipts of not more than $5,000 during each of their first four years*	$ 150
Initial application for exempt status from organizations otherwise described above whose actual or anticipated gross receipts exceed the $5,000 average annually	$ 300
Request for termination of private foundation status	$ 200
*Organizations seeking the reduced fee must sign a certification with their applications that the receipts are or will be not more than the indicated amounts.	
6. *Other Determination Letters*	
Determination letters governed by Rev. Proc. 88-1 and Rev. Proc. 87-4 concerning income tax, estate tax, gift tax, excise tax, employment tax, and administrative provisions matters	$ 200

.04 *Submissions Involving Several Offices, Subcategories, Issues, or Unrelated Transactions.* If a request dealing with only one transaction involves more than one of the offices within the National Office of the Service (for example, one issue is under the jurisdiction of the Associate Chief Counsel (Technical and International) and another issue is under the jurisdiction of the Assistant Commissioner (Employee Plans and Exempt Organizations)), or if a ruling request is within more than one subcategory, only one fee applies, namely the highest fee that otherwise would apply to each of the offices or subcategories involved. A separate fee will apply with respect to each unrelated transaction where a request involves several unrelated transactions or the request is changed by the addition of an unrelated transaction not contained in the initial submission. However, the addition of a new issue relating to the same transaction will not result in an additional fee, except when the issue places the transaction in a higher fee category.

.05 *Method of Payment.* Each request to the Service for a ruling, determination letter or opinion letter must be accompanied by a check or money order, payable to the Internal Revenue Service, in the appropriate amount. (However, the user fee check or money order should not be attched to the Form 2553, Election by a Small Business Corporation, when it is filed at the Service Center. If on the Form 2553 the corporation requests a ruling that it be permitted to use a fiscal year under section 6.03 of Rev. Proc. 87-32, the Service Center will forward such request to the National Office. When the National Office receives the Form 2553 from the Service Center it will notify the taxpayer that the fee is due). Taxpayers should not send cash.

.06 *Mailing Address for Requesting Rulings, Determination Letters, Etc.*

1. A request for a ruling letter submitted pursuant to Rev. Proc. 88—1 or Rev. Proc. 87-4 should be sent to the Internal Revenue Service, Associate Chief Counsel (Technical and International), Attention: CC:IND:D:C, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044. Requests may be hand delivered to Room 6561, 1111 Constitution Avenue, N.W., Washington, D.C.

2. A request for a determination letter submitted pursuant to Rev. Proc. 88-1 or Rev. Proc. 87-4 should be sent to the District Director of Internal Revenue whose office has or will have examination jurisdiction over the taxpayer's return.

3. Requests for rulings or opinion letters including those submitted pursuant to Rev. Proc. 83-36, 84-23 or 87-50 should be sent to the following address:

(a) *Employee plan rulings*
Internal Revenue Service
Assistant Commissioner (Employee Plans and Exempt Organizations)
Attention: E:EP:R
P.O. Box 14073, Ben Franklin Station
Washington D.C. 20044

(b) *Exempt organization rulings*
Internal Revenue Service
Assistant Commissioner (Employee Plans and Exempt Organizations)
Attention: E:EO
P.O. Box 120, Ben Franklin Station
Washington, D.C. 20044

(c) *Employee plan opinion letters*
Internal Revenue Service
Assistant Commissioner (Employee Plans and Exempt Organizations)
Attention: E:EP:Q
P.O. Box 14073, Ben Franklin Station
Washington, D.C. 20044

4. Requests for determination letters submitted pursuant to Rev. Proc. 80-30, 83-36 or 84-46, and requests for notification letters submitted pursuant to Rev. Proc. 84-86, should be sent to the following address:

If entity is in this IRS District	Send request for determination letter or notification letter to this address:
For Employee Plans and Exempt Organizations:	
Brooklyn, Albany, Augusta, Boston, Buffalo, Burlington, Hartford, Manhattan, Portsmouth, Providence	Internal Revenue Service EP/EO Division P.O. Box 1680 GPO Brooklyn, NY 11202
Baltimore, District of Columbia, Pittsburgh, Richmond, Newark, Philadelphia, Wilmington, any U.S. possession or foreign country	Internal Revenue Service EP/EO Division P.O. Box 17010 Baltimore, MD 21203
Cincinnati, Cleveland, Detroit, Indianapolis, Louisville, Parkersburg	Internal Revenue Service EP/EO Division P.O. Box 3159 Cincinnati, OH 45201
Dallas, Albuquerque, Austin, Cheyenne, Denver, Houston, Oklahoma City, Phoenix, Salt Lake City, Wichita	Internal Revenue Service EP/EO Division 1100 Commerce Street Mail Code 4950 DAL Dallas, TX 75242
For Employee Plans Only:	
Atlanta, Birmingham, Columbia, Greensboro, Jackson, Jacksonville, Little Rock, Nashville, New Orleans	Internal Revenue Service EP/EO Division P.O. Box 941, Room 1112 Atlanta, GA 30301
Chicago, Aberdeen, Des Moines, Fargo, Helena, Milwaukee, Omaha, St. Louis, St. Paul, Springfield	Internal Revenue Service EP/EO Division 230 S. Dearborn DPN 20-6 Chicago, IL 60604
Honolulu, Laguna Niguel, Las Vegas, Los Angeles, San Jose	Internal Revenue Service EP Application Receiving Room 5127, P.O. Box 536 Los Angeles, CA 90053-0536
Sacramento, San Francisco	Internal Revenue Service EP Application Receiving P.O. Box 36001 Stop SF 4446 San Francisco, CA 94102
Anchorage, Boise, Portland, Seattle	Internal Revenue Service EP Application Receiving P.O. Box 21224 Seattle, WA 98111
For Exempt Organizations Only:	
Atlanta, Birmingham, Columbia, Greensboro, Jackson, Jacksonville, Little Rock, Nashville, New Orleans	Internal Revenue Service EP/EO Division C-1130 Atlanta, GA 30301
Chicago, Aberdeen, Des Moines, Fargo, Helena, Milwaukee, Omaha, St. Louis, St. Paul, Springfield	Internal Revenue Service EP/EO Division 230 S. Dearborn DPN 20-5 Chicago, IL 60604

If entity is in this IRS District	**Send request for determination letter or notification letter to this address:**
For Exempt Organizations Only:	
Anchorage, Las Vegas, Boise, Los Angeles, Honolulu, Portland, Laguna Niguel, San Jose, Seattle	Internal Revenue Service EO Application Receiving Room 5127, P.O. Box 486 Los Angeles, CA 90053-0486
Sacramento, San Francisco	Internal Revenue Service EO Application Receiving P.O. Box 36001 Stop SF 4446 San Francisco, CA 94102

.07 *Effect of Nonpayment or Payment of Incorrect Amount.* It will be the general practice of the Service that:

1. Except as provided in 5 below, if a request is not accompanied by a properly completed check or money order (for example, a check has not been signed), the entire submission will be returned to the submitter, along with the check or money order.
2. Except as provided in 5 below, if a check or money order is for less than the correct amount, the entire submission will be returned to the submitter, along with the check or money order.
3. The return of a submission to the submitter pursuant to paragraph 1 or 2 of this subsection may adversely affect substantive rights if the submission is not perfected and resubmitted to the Service within 30 days of the date of the cover letter returning the submission. For example, where an application for a determination letter is submitted prior to the expiration of the remedial amendment period under section 401(b) of the Code and is returned because no user fee was attached, the submission will be timely if it is resubmitted by the expiration of the remedial amendment period or, if later, within 30 days after the application was returned.
4. If a check or money order is for more than the correct amount, the submission will be accepted and the amount of the excess payment will be returned to the submitter.
5. For 60 days following publication of this procedure, submissions that are not accompanied by the correct amount will not be returned for this reason. Instead, the submitter will be contacted and given a reasonable time to submit the proper fee. If the fee is not received in a reasonable time, the entire submission will be returned. However, the Service, in its discretion, may defer substantive consideration of the submission until proper payment has been received. At the end of the 60-day period, the Service will evaluate whether this practice should be extended.

.08 *Refunds.* In general, the fee will not be refunded unless the Service declines to rule on all issues for which a ruling is requested.

1. The following are examples of situations in which the fee will not be refunded:
   (a) The request for a ruling, determination letter, etc. is withdrawn at any time subsequent to its receipt by the Service.
   (b) The request is procedurally deficient, although accompanied by the proper fee or an overpayment, and is not timely perfected by the submitter. Where there is a failure to timely perfect the request, the case will be considered closed and the failure to perfect will be treated as a withdrawal for purposes of this revenue procedure.
   (c) A ruling, determination letter, etc. is revoked in whole or in part at the initiative of the Service. The fee paid at the time the original ruling, determination letter, etc. was requested will not be refunded.
   (d) A request contains several issues and the Service rules on some, but not all, of the issues. The highest fee applicable to the issues on which the Service rules will not be refunded.
   (e) The taxpayer asserts that a ruling it received covering a single issue is erroneous or not responsive (other than with respect to any issue on which the Service has declined to rule) and requests reconsideration. The Service, upon reconsideration, does not agree that the ruling is erroneous or not responsive. The fee accompanying the request for reconsideration will not be refunded.
   (f) The situation is the same as described in (e) immediately above except that the ruling covered several unrelated transactions. The Service, upon reconsideration, does not agree with the taxpayer that the ruling is erroneous or nonresponsive with respect to all of the transactions, but does agree that it is erroneous with respect to one transaction. The fee accompanying the request for reconsideration will not be refunded except to the extent applicable to the transaction with respect to which the Service agrees the ruling was in error.
   (g) The request is for a supplemental ruling, determination letter, etc. concerning a change in

facts (whether significant or not) relating to the transaction ruled on.

(h) The request is for reconsideration of an adverse or partially adverse ruling or a final adverse determination letter, and the taxpayer submits arguments and authorities not submitted before the original ruling or determination letter was issued.

2. The following are examples of situations in which the fee will be refunded:

(a) In a situation to which section 4.081(h) above does not apply, the taxpayer asserts that a ruling it received covering a single issue is erroneous or not responsive (other than with respect to any issue on which the Service declined to rule) and requests reconsideration. The Service agrees, upon reconsideration, that the ruling is erroneous or not responsive. The fee accompanying the taxpayer's request for reconsideration will be refunded.

(b) In a situation to which section 4.081(h) above does not apply, the taxpayer requests a supplemental ruling, determination letter, etc. to correct a mistake that the Service agrees it made in the original ruling, determination letter, etc., such as a mistake in the statement of facts or in the citation of a Code section. Once the Service agrees that it made a mistake, the fee accompanying the request for the supplemental ruling will be refunded.

(c) The taxpayer requests and is granted relief under section 7805(b) of the Code in connection with the revocation, in whole or in part, of a previously issued ruling, determination letter, etc. The fee accompanying the request for relief will be refunded.

.09 *Exemptions*. The user fee requirement of this revenue procedure shall not apply to departments, agencies, or instrumentalities of the United States that certify that they are seeking a ruling, determination letter, opinion letter or similar letter on behalf of a program or activity funded by federal appropriations. The fact that a user fee is not charged shall have no bearing on whether an applicant is treated as an agency or instrumentality of the United States for purposes of any provision of the Internal Revenue Code.

SEC. 5. QUESTIONS AS TO APPLICABILITY OR AMOUNT OF FEE

A taxpayer or organization that believes the user fee charged by the Service for its request for a ruling, determination letter, etc. is either not applicable or incorrect may request reconsideration and, if desired, the opportunity for an oral discussion by sending a letter to the Internal Revenue Service at the applicable Post Office Box or other address given in section 4.06 above. Both the incoming envelope and the letter requesting such reconsideration should be prominently marked "USER FEE RECONSIDERATION REQUEST" and the request should be marked for the attention of:

If the matter involves primarily	*Send request to*
Associate Chief Counsel (Technical and International) ruling requests submitted pursuant to Rev. Proc. 88-1	Associate Division Director __________ Division (add name of the division handling the request)
Associate Chief Counsel (Technical and International) ruling requests submitted pursuant to Rev. Proc. 87-4	Deputy Associate Chief Counsel (International)
Employee plan ruling and opinion letter requests	Chief, Rulings Branch E:EP:R
Exempt organization ruling requests	Chief, Rulings Branch E:EO:R
Employee plan and/or exempt organization determination letter requests	Chief, Technical Staff __________ Key District Office (add name of key district office handling the request)
Determination letter requests submitted pursuant to Rev. Proc. 88-1 or Rev. Proc. 87-4	Chief, Quality Review Staff __________ District Office (add name of district office handling the request)

SEC. 6. EFFECT ON OTHER DOCUMENTS

Rev. Procs. 80-30, 83-36, 84-23, 84-46, 84-86, 87-4, 87-50 and 88-1 are modified and amplified to the extent that this revenue procedure provides for an additional requirement that must be satisfied in requesting a ruling, determination letter, or opinion letter pursuant to those revenue procedures.

SEC. 7. EFFECTIVE DATE

This revenue procedure applies to requests postmarked or, if not mailed, received on or after February 1, 1988. This revenue procedure does not apply to requests filed on or after September 30, 1990. This revenue procedure is corrected as modified by Rev. Proc. 88-13, page 639, this Bulletin.

---

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 88-9

SECTION I. PURPOSE

This revenue procedure sets forth special procedures of the Internal Revenue Service pertaining to the issuance of determination letters on the qualification of pension, profit-sharing and stock bonus plans that will be terminated prior to the delayed amendment date provided in section 1140 of the Tax Reform Act of 1986 (TRA '86), Pub. L. 99-514.

SEC. 2. BACKGROUND AND GENERAL INFORMATION

.01 Rev. Proc. 80-30, 1980-1 C.B. 685, sets forth the general procedures of the Service relating to the issuance of determination letters on the qualification of pension, profit-sharing, and stock bonus plans, including determination letters involving the termination of such plans.

.02 Section 1140 of TRA '86 provides that qualified plans need not be amended for any provision in subtitle A or C of Title XI until the first plan year beginning after December 31, 1988, so long as such amendment applies retroactively to the period during which the provision is in effect. For plans maintained pursuant to collective bargaining agreements ratified before March 1, 1986, section 1140 provides that such plans must be amended by the first plan year beginning after the earlier of: (1) the later of January 1, 1989, or the date on which the last collective bargaining agreement terminates (without regard to extensions made after February 28, 1986); or (2) January 1, 1991.

.03 Notice 86-13, 1986-2 C.B. 377, provides that, until further notice, determination letter requests concerning qualification of pension, profit-sharing and stock bonus plans will not be reviewed for qualification requirements changed by TRA '86 other than certain retroactive technical corrections.

.04 Notice 87-57, 1987-2 C.B. 368, modifies Notice 86-13. Notice 87-57 states that the Service will review requests for determination letters on the basis of the law currently in effect with respect to plans being terminated prior to the delayed amendment date provided in section 1140 of TRA '86. Plans terminating prior to that date must be amended to reflect provisions in TRA '86 that are effective as of the date of termination, the temporary REA regulations, as well as the Technical Corrections to the Tax Reform Act of 1984, Pub. L. 98-369, 1984-3 C.B. 1, and to the Retirement Equity Act of 1984 (REA), Pub. L. 98-397, 1984-2 C.B. 433.

.05 Notice 87-20, 1987-1 C.B. 456, provides guidance in complying with section 1139 of TRA '86. In general, the interest rates used to determine present values and amounts of certain plan benefits paid from a defined benefit plan in plan years beginning after 1984 must not exceed the "section 1139" rates. However, there are exceptions for distributions that meet the requirements of temporary regulations under REA or that were corrected for underpayment before August 10, 1987.

.06 Notice 87-21, 1987-1 C.B. 458, describes new limitations on plan contributions and benefits under section 415 of the Code as enacted by TRA '86. These new limitations generally apply for limitation years beginning after 1986. However, transitional rules and an exception for plans maintained pursuant to collective bargaining agreements are provided in section 1106(i) of TRA '86.

SEC. 3. REQUIRED AMENDMENTS FOR TERMINATING PLANS

.01 In order to receive a favorable determination letter, qualified plans terminating prior to the delayed amendment date provided in section 1140 of TRA '86 must be amended to reflect the law in effect at the time of termination. These requirements include certain provisions of TRA '86, the Technical Corrections in Title XVIII of TRA '86 and the Temporary Income Tax Regulations under REA.

.02 In Notice 87-2, 1987-1 C.B. 396, the Service published model amendments I-IV that may be used by individually designed plans to comply with TRA '86. In Notice 87-33, 1987-1 C.B. 480, two model amendments were published for sponsors of master and prototype plans. These amendments may be adopted to satisfy requirements of this Revenue Procedure with regard to the provisions of TRA '86, other than the Technical Corrections in Title XVIII, that are effective for plan years beginning before January 1, 1989. If the sponsor of a master or prototype plan has not adopted the appropriate model amendment as described in Notice 87-33 by the date of plan termination, the adopting employer may adopt the appropriate model amendment for individually designed plans.

.03 The simplified model amendment for section 415 of the Internal Revenue Code provided in Notice 87-21, 1987-1 C.B. 458, may not be used to satisfy the section 415 requirements for a terminating plan. The model amendments provided in Notice 87-2 or Notice 87-33 will satisfy the section 415 requirements.

.04 In addition to the requirements listed in this section, other requirements that become effective with respect to plans terminating after the effective date of this revenue procedure may also require plan amendment. For example, if changes in the qualification requirements made by the Omnibus Budget Reconciliation Act of 1986 (OBRA), Pub. L. 99-509, are effective with respect to a plan, amendments may be required to comply with those changes on or before plan termination.

SEC. 4. FILING INSTRUCTIONS

.01 The requirements of Rev. Proc. 80-30, 1980-1 C.B. 685, are to be followed in requesting a determination of a plan's qualified status from the appropriate Key District Director.

.02 An application for a determination letter is made on a Form 5310, accompanied by a Form 6088 or statement of actuarial evaluation describing distributions to participants. Copies of plan amendments made since the most recent determination letter was issued must also be submitted.

SEC. 5. SUPPLEMENTAL INFORMATION REQUIRED

Applications for a determination letter on termination of a qualified plan prior to the delayed amendment date of section 1140 of TRA '86 must be accompanied by the following representations, where applicable:

.01 In the case of a defined benefit plan, a representation that any distribution made after December 31, 1984, complied with section 1139 rates (or the temporary REA regulations if made before 1987), or were corrected to do so by August 10, 1987.

.02 A statement as to whether annual additions, benefit accruals, or benefit payments have been made in excess of the applicable section 415 limitations, and which, if any, exception or transitional provision referenced in Section 2.06 of this revenue procedure is applicable.

SEC. 6. EFFECT ON OTHER DOCUMENTS

Section 4.09 of Rev. Proc. 80-30 is hereby modified to require the submission of the supplemental information in section 6 above, in connection with applications for determination letters involving plans terminating prior to the date provided in section 1140 of TRA '86.

SEC. 7. EFFECTIVE DATE

The special procedures set forth in this revenue procedure are effective January 25, 1988. Applications submitted more than 30 days after January 25, 1988, must be accompanied by the appropriate supplemental information described in Sec. 5.01 and Sec. 5.02.

---

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 88-10

SECTION 1. PURPOSE

This revenue procedure provides guidance to issuers of state or local bonds for requesting an extension of time to file the statement of information required by section 149(e) of the Internal Revenue Code of 1986.

SEC. 2. BACKGROUND

.01 The Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 1, 567, amended and reorganized the sections of the 1954 Code pertaining to information reporting for certain state or local bonds. Former section 103(l), pertaining to information reporting for private purpose bonds, and former section 103A(j)(3)(A), pertaining to information reporting for qualified mortgage bonds, were consolidated in new section 149(e) of the 1986 Code, which requires information reporting for any state or local bond.

.02 Section 103(a) of the 1986 Code provides that, with certain exceptions, gross income does not include interest on any state or local bond.

.03 Internal Revenue Service News Release IR-83-152, dated December 14, 1983, announced procedures for issuers of private purpose bonds to request relief from the consequences of the late filing of information reports. News Release IR-83-152 was published as Announcement 84-51, 1984-20 I.R.B. 14.

.04 Section 149(e)(1) of the 1986 Code provides that interest on a state or local bond will not be excludable from gross income unless certain information reporting requirements are satisfied. The issuer must submit a statement that contains the information required under section 149(e)(2). The statement must be submitted not later than the 15th day of the 2nd calendar month after the close of the calendar quarter in which the bond is issued (or such later time as the Secretary may prescribe with respect to any portion of the statement).

.05 In general, the statement required by section 149(e)(2) of the 1986 Code must be filed on one of the following forms: Form 8038, Information Return for Tax-Exempt Private Activity Bond Issues Under Section 149(e); Form 8038-G, Information Return for Tax-Exempt Governmental Bond Issues Under Section 149(e); or Form 8038-GC, Consolidated Information Return for Small Tax-Exempt Governmental Bond Issues Under Section 149(e).

.06 Section 1.149(e)-1T(d)(2)(ii) of the Temporary Income Tax Regulations provides that the Commissioner may grant an extension of time to file any form required under this section if the Commissioner determines that the failure to file in a timely manner was not due to willful neglect.

SEC. 3. PROCEDURES

.01 An issuer of a state or local bond who fails to timely submit the statement (Form 8038, 8038-G, or 8038-GC) required by section 149(e)(2) of the 1986 Code should take the following action after discovery of the failure:

(1) Mail the statement to the Internal Revenue Service, Philadelphia Service Center, Statistics of Income Unit, P:DA:Unit F-SOI, Philadelphia, Pennsylvania 19255, Stop # 335. The words, "This Statement Is Submitted In Accordance With Rev. Proc. 88-10," should be typed or printed across the top of the statement.

(2) Attach the statement to a letter briefly setting forth the reasons why the statement was not timely submitted to the Service. The letter should also indicate whether the bond issue in question is under examination by the Service. Copies of the trust indenture or other bond documents should not be submitted with the letter.

.02 The S.O.I. Unit will acknowledge receipt of the letter and statement within 30 days after they are received. If the S.O.I. Unit determines that the failure to file the statement is not due to willful neglect, it will so inform the issuer in writing within this 30-day period. If the S.O.I. Unit is unable to determine that the failure to file the statement is not due to willful neglect, it will inform the issuer in writing within this 30-day period that the matter has been referred for technical advice to the Associate Chief Counsel (Technical and International) at the National Office of the Internal Revenue Service in Washington, D.C. If after an analysis of the technical advice request it appears that advice adverse to the issuer will be given, the issuer is entitled to a conference in the National Office in accordance with the procedures set forth in section 8 of Rev. Proc. 88-2, page 571, this Bulletin. The S.O.I. Unit will inform the issuer in writing of the results of the request for technical advice within 30 days after the technical advice memorandum is received from the National Office.

SEC. 4. EFFECT OF DETERMINATION

.01 If the failure to timely file the statement is not due to willful neglect, then the filing of the statement in section 3.01 above is accepted, and the information reporting requirement of section 149(e)(1) of the 1986 Code is deemed satisfied.

.02 If the failure to timely file the statement is due to willful neglect, then the filing of the statement in section 3.01 is not accepted, and the information reporting requirement of section 149(e)(1) is not deemed satisfied. In such case, the interest on the bond is not excludable from gross income under section 103(a) of the 1986 Code.

SEC. 5. EFFECTIVE DATE

This revenue procedure is effective January 25, 1988.

SEC. 6. EFFECT ON OTHER DOCUMENTS

Announcement 84-51 is superseded.

---

26 CFR 601.702: Publication and public inspection.
(Also Part I, Section 6110; 301.6110-1.)

Rev. Proc. 88-11

SECTION 1. PURPOSE

The purpose of this revenue procedure is to provide guidance to the public on the filing of requests under section 6110 of the Internal Revenue Code to obtain background file documents relating to a ruling letter or a technical advice memorandum issued by the National Office of the Internal Revenue Service.

SEC. 2. BACKGROUND

The National Office of the Internal Revenue Service issues ruling letters to taxpayers and provides technical advice to District Directors and Appeals Offices. See Revenue Procedures 88-1, page 557, this Bulletin; 88-2, page 571, this Bulletin; 87-4, 1987-1 C.B. 529; 87-5, 1987-1 C.B. 535; 83-36, 1983-1 C.B. 763; and 80-26, 1980-1 C.B. 671.

A ruling letter is a written statement issued to a taxpayer by the National Office that interprets and applies the tax law to that taxpayer's specific set of facts. Ruling letters are issued only by the National Office.

Technical advice means advice or guidance furnished by the National Office upon request of a District Director or an Appeals Office in response to any technical or procedural question that develops during any stage of any proceeding on the interpretation and proper application of tax law, tax treaties, regulations, revenue rulings, or other precedents published by the National Office to a specific set of facts.

The National Office generally makes ruling letters and technical advice memorandums available for public inspection in the National Office Reading Room. See Section 5.02 of this procedure for location and telephone number. The Disclosure Staff of the Associate Chief Counsel (Technical and International) is responsible for processing, numbering, and releasing these documents for public inspection. The Staff also processes requests for background file documents for any ruling letter or technical advice memorandum issued by the National Office.

SEC. 3. LAW

Section 6110(a) of the Code provides, generally, that the text of any background file document relating to a written determination will be open to public inspection at the place prescribed by the Secretary.

Section 6110(b)(1) of the Code defines "written determination" as a ruling letter, determination letter, or technical advice memorandum. Section 6110(b)(2) states that the term "background file document" includes the request for the written determination, any written material submitted in support of the request, and any communication between the Internal Revenue Service and persons outside the Service in connection with the written determination that was received before issuance of the written determination.

Section 6110(c) of the Code provides, in part, that before making any background file document open or available to public inspection the Secretary shall delete certain specified material.

Section 6110(f) of the Code provides that, upon receipt of a request for a background file document, the Secretary shall mail to any person to whom the written determination pertains, a notice of intention to disclose the document. Administrative remedies and judicial action to restrain disclosure that may be availed of by the person to whom the document pertains are provided for under section 6110(f).

Section 6110(g) of the Code provides, generally, that a background file document, as modified by deletions made under section 6110(c), shall be available for public inspection not earlier than 75 days or later than 90 days after the notice of intention to disclose is mailed.

Section 6110(j)(1) of the Code authorizes the Secretary to assess actual costs for search, deletion, and duplication of background file documents. The section further provides that the Secretary will furnish any document without charge or at a reduced charge if it is determined that waiver or reduction of the fee is in the public interest because furnishing such document can be considered as primarily benefiting the general public.

SEC. 4. SCOPE

This revenue procedure applies to requests for background file documents (documents) pertaining to a ruling letter or a technical advice memorandum issued by the National Office.

This procedure does not apply to a determination letter. A determination letter is a written statement issued by a District Director in response to a written inquiry by a taxpayer that applies the principles and precedents previously announced by the National Office to a specific set of facts. For procedures for requesting documents pertaining to a written determination issued by a District Director, see section 301.6110-1(c) of the Regulations on Procedure and Administration.

SEC. 5. PROCEDURE

.01 *Requests.* Requests for documents must be in writing and must include the file number of the ruling letter or the technical advice memorandum. The request should specify whether it is for all the documents in the file or only a specific document. For example, a requester may request only the trust agreement (or the will, partnership agreement, plan of reorganization, etc.) that was the subject of the ruling letter or technical advice memorandum.

See Section 5.07 of this procedure for a sample of a request letter for documents under section 6110 of the Code.

.02 *File Numbers.* Ruling letters and technical advice memorandums are indexed by Internal Revenue Code sections. File numbers for the ruling letters and technical advice memorandums under specific Code sections may be obtained from the National Office Reading Room, Room 1569, IRS Building, 10th and Pennsylvania Avenue, N.W., Washington, DC, 20224. The Reading Room is open from 9:00 a.m. to 4:00 p.m., Monday through Friday, and the telephone number is (202) 566-3770 (not a toll-free call).

.03 *Fees.* Requests for documents should contain authorization for the Service to charge the person making the request the costs for searching for the file, making deletions, and making copies. The request should state the maximum amount of charges the Service may incur without further authorization from the person making the request. If the request for documents does not contain a stated maximum amount or the fees will exceed the stated maximum amount, the Service will forward to the requester a payment agreement with the estimated cost for processing the file. The payment agreement must be signed and returned to the Service before processing of the file will begin.

The fees for processing documents are:

Search Fee—$13.00 for each ruling letter file or technical advice memorandum file.

Deletion and Duplication Fee—$2.30 per page.

.04 *Mailing Address.* Requests for documents should be sent to:

Internal Revenue Service
Attn: CC:IND:D
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

.05 *Release Date.* Documents are ordinarily made available to the requester between 90 and 120 days after receipt of the request for the documents. This allows the Service the time necessary to notify the person to whom the documents pertain of its intention to disclose them. If the documents have previously been requested and processed, the documents will ordinarily be available within two weeks of the receipt of the request.

.06 *Payment of Fees.* Payment of the processing fees must be made before the documents will be released to the requester. The person making the request will be notified by letter of the total cost of processing the documents.

.07 *Sample Request.* The following is a sample of a request letter for documents under section 6110 of the Code.

Internal Revenue Service Date____

Attn: CC:IND:D
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Dear Sir or Madam:

This is a request under section 6110 of the Code for the background file documents relating to ruling letter *(File Number)* or technical advice memorandum *(File Number)*.

(Option) I am requesting a copy of all of the documents in the file.

(Option) I am requesting only a copy of *(Specify Document)*.

I am willing to pay fees for this request up to a maximum of $________________. If you estimate that the fees will exceed this limit, please inform me before processing the documents.

I understand that I will be notified of the fees before the documents are scheduled for release and that payment must be made before the documents are released to me.

Sincerely,

Name
Address
City, State, Zip Code
Telephone Number

SEC. 6. INQUIRIES

Inquiries regarding this procedure should be directed to Chief, Disclosure Staff, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC, 20044 or by calling (202) 566-3129 (not a toll-free call).

---

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.

Rev. Proc. 88-12

SECTION 1. PURPOSE

This revenue procedure provides a method for reducing the "excess tax reserve" for certain public utility taxpayers. In general, the method satisfies the requirements of section 203(e) of the Tax Reform Act of 1986 (the Act), 1986-3 (Vol. 1) C.B. 63, if used by taxpayers that are unable to utilize the average rate assumption method because they have been required by a regulatory agency to compute depreciation on public utility property on the basis of an average-life or composite rate method, as opposed to a method involving the use of vintage accounts.

SEC. 2. BACKGROUND

.01 Under a normalization method of accounting, the amount of tax expense that a taxpayer reports for ratemaking purposes includes a deferred tax amount to reflect the fact that the taxpayer is using an accelerated method of depreciation for federal income tax purposes. For taxable years beginning on or after July 1, 1987, section 601 of the Act, 1986-3 (Vol. 1) C.B. 166, reduces from 46 percent to 34 percent the maximum federal income tax applicable to corporations. Section 203(e) of the Act provides rules for reducing the excess tax reserve resulting both from that reduction and from the smaller reduction in rates for tax years starting before and ending after (straddling) July 1, 1987.

.02 Section 203(e) of the Act provides that normalization method of accounting shall not be treated as being used with respect to any public utility property, for purposes of section 167 or 168 of the Internal Revenue Code, if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces its excess tax reserve more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method. Section 203(e)(2)(A) of the Act defines the term "excess tax reserve" as the excess of (i) the reserve for deferred taxes, described in section 167(*l*)(3)(G)(ii) of the Code (or former section 168(e)(3)(B)(ii) as in effect on the day before the enactment of the Act), over (ii) the amount that would be the balance in the reserve if the amount of the reserve were determined by assuming that the corporate tax rates provided by the Act were in effect for all prior periods. Section 203(e) also applies with respect to the excess tax reserve that occurs from the normalization requirement that taxpayers provide for deferred taxes at a rate in excess of 34 percent for any tax year (for example, a calendar year) that straddles July 1, 1987.

.03 The legislative history of the Act, however, indicates that section 203(e) of the Act does not apply to any amount of excess tax reserve generated from reductions in corporate tax rates that occurred before the enactment of the Act. For example, section 203(e) does not apply to any excess tax reserve resulting from the reduction in the maximum corporate tax rate from 48 percent to 46 percent under the Revenue Act of 1978, section 301, 1978-3 (Vol. 1) C.B. 54. *See* S. Rep. No. 313, 99th Cong., 2d Sess. 98 (1986), 1986-3 (Vol. 3) C.B. 98 (Senate Report); H.R. Rep. No. 426, 99th Cong., 1st Sess. 149 (1985), 1986-3 (Vol. 2) C.B. 149 (House Report). The provisions of prior law apply to the treatment of any excess tax reserve occurring from such previous rate reductions. Of course, a taxpayer may use the average rate assumption method with respect to any excess tax reserve, including a reserve to which section 203(e) does not apply, without violating the normalization rules.

Moreover, the provisions of section 203(e) of the Act apply only with respect to the excess tax reserve resulting from depreciation occurring in years beginning before July 1, 1987, with respect to assets placed in service before January 1, 1987. See Senate Report at 98; *see also* House Report at 149.

Finally, the provisions of section 203(e) apply only with respect to the excess tax reserve resulting from depreciation "timing" differences that were required to be normalized under section 167 or 168 of the Code. Thus, for example, section 203(e) of the Act does not apply to the excess tax reserve resulting from the normalization of other book/tax timing differences, as described in section 1.167(*l*)-1(a)(1) of the Income Tax Regulations (for example, state income taxes). *Cf.* Rev. Rul. 87-139, 1987-2 C.B. 65, which concludes that section 203(e) applies to the "voluntary" normalization method adopted by a taxpayer as described in that ruling.

.04 Section 203(e)(2)(B) of the Act defines the average rate assumption method as the method under which the excess tax reserve is reduced over the remaining lives of the property (as used in a public utility's regulated books of account) that gave rise to the reserve for deferred taxes. Under this method, the amount of the annual adjustment to the reserve for deferred taxes is the product of (i) the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property (the applicable average rate), and (ii) the amount of the timing differences that reverse during the year. The calculation is made as of the beginning of the year in which timing differences in the vintage account begin to reverse, that is, the first year in which the tax depreciation taken with respect to the vintage account is less than the amount of depreciation reflected in the regulated books of account computed on the tax basis. Thus, under the average rate assumption method, excess tax reserves pertaining to a particular vintage or vintage account are not flowed-through to ratepayers until such time as the timing differences in the particular vintage account reverse. Moreover, it is a violation of section 203(e) of the Act for taxpayers to adopt any accounting treatment that, directly or indirectly, circumvents the rule set forth in the previous sentence.

In addition, section 203(e) of the Act does not modify the normalization requirements of section 167(*l*) or section 168(i) of the Code. For example, a violation of the normalization rules occurs if a taxpayer provides for deferred taxes with respect to a particular vintage account at a tax rate less than the statutory rate applicable to the taxpayer for the current year in question.

.05 Some taxpayers have been required by regulatory agencies to depreciate property for regulatory purposes using a weighted average life or composite rate. A method of depreciation that uses a weighted average life or composite rate focuses on the entire plant and does not account for property by vintage accounts. Consequently, taxpayers that use this method may not have adequate data to apply the average rate assumption method.

SEC. 3. SCOPE

A taxpayer is described in this section 3 if, as of the first day of the taxable year that includes July 1, 1987, (i) the taxpayer was required by a regulatory agency to compute depreciation for public utility property on the basis of an average life or composite rate method, and (ii) the taxpayer's books and underlying records did not contain the vintage account data necessary to apply the average rate assumption method. If a taxpayer is subject to the jurisdiction of more than one regulatory body, the determination of the adequacy of the vintage accounting records for each asset or group of assets shall be determined on a jurisdiction-by-jurisdiction basis.

SEC. 4. DEFINITION OF REVERSE SOUTH GEORGIA METHOD

.01 In general, a taxpayer uses a method described in this section 4 if it (a) computes the excess tax reserve on all public utility property included in the plant account on the basis of the weighted average life or composite rate used to compute depreciation for regulatory purposes, and (b) reduces the excess tax reserve ratably over the remaining regulatory life of the property. This method is sometimes referred to as the "Reverse South Georgia Method."

.02 *Special rule if a taxable year straddles July 1, 1987.* A taxpayer uses the method described in section 4 if the excess tax reserve is computed as of the first day of the year by subtracting from the reserve for deferred taxes (described in section 167(*l*) or 168(i)(9) of the Code) the amount that would be the balance of such reserve if the amount were determined by assuming that the weighted average tax rate for the year were in effect for all prior periods. (However, any reserve amount to which section 203(e) of the Act does not apply, as discussed in section 2.03 of this revenue procedure, is not required to be included in the excess tax reserve that is subject to ratable reduction under the Reverse South Georgia Method. Instead, the requirements of prior law apply to any such reserve amount). For a taxable year that straddles July 1, 1987, any reasonable method of calculating the weighted average tax rate shall be allowed under section 203(e). For example, under one acceptable method, the weighted average tax rate may be computed by using the marginal tax rate (46 percent) for the portion of the taxable year prior to July 1, 1987, and the marginal tax rate (34 percent) for the portion of the taxable year after July 1, 1987, weighted by the number of days in each period.

If the taxpayer has a taxable year that straddles July 1, 1987, then the taxpayer uses the method described by this section 4 for its succeeding taxable year if the excess tax reserve as of the first day of the succeeding taxable year is redetermined by subtracting from the reserve for deferred taxes (described in section 167(*l*) or 168(i)(9) of the Code) the amount that would be the balance of such reserve if the amount were determined by assuming that a 34 percent tax rate had been in effect for all prior periods. Redeterminations of the excess tax reserve are not made for subsequent years. Adjustments to the unamortized excess tax reserve may only be made to reflect asset retirements.

SEC. 5. APPLICATION

.01 If a taxpayer that is described in section 3 of this revenue procedure with respect to a jurisdiction uses the Reverse South Georgia Method described in section 4 for public utility property that is subject to the regulatory authority of that jurisdiction, then with respect to that property for that taxable year the taxpayer is deemed to satisfy the normalization requirements of section 203(e) of the Act.

.02 The use of the method described in section 4 by a taxpayer whose books and underlying records contain vintage year data for public utility property constitutes a violation of the requirements contained in section 203(e) of the Act if that method reduces the excess tax reserve more rapidly than the reserve would be reduced under the average rate assumption method.

SEC. 6. EFFECTIVE DATE

This revenue procedure is effective for any taxable year subject to section 203(e) of the Act.

---

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 88-13

SECTION 1. PURPOSE

The purpose of this revenue procedure is to modify Rev. Proc. 88-8, page 628, this Bulletin, which requires the payment of a user fee for requests to the Internal Revenue Service for rulings, opinion letters, determination letters, and similar requests.

SEC. 2. PROCEDURES

.01 Section 4.031 of Rev. Proc. 88-8 is modified to provide a user fee charge of $150 for a newly electing S corporation filing a Form 2553, Election by a Small Business Corporation, and requesting a fiscal year under section 6.03 of Rev. Proc. 87-32, 1987-2 C.B. 396. Section 4.031, as modified, reads as follows:

Applications with respect to accounting periods (Forms 1128 and 2553)	$150
Change in Accounting Method (Form 3115)	$200
Earnings and Profits determinations (Form 5452).........	$200
All other rulings (which includes accounting period, accounting method, and earnings and profits requests other than those submitted on Forms 1128, 2553, 3115, and 5452)......................	$300

.02 Section 4.05 of Rev. Proc. 88-8 is modified to provide that the user fee check or money order should not be attached to the Form 2553 when filed at the Service Center. When the National Office receives Form 2553 from the Service Center it will notify the taxpayer that the fee is due. Section 4.05, as modified, reads as follows:

.05 Method of Payment. Each request to the Service for a ruling, determination letter or opinion letter must be accompanied by a check or money order, payable to the Internal Revenue Service, in the appropriate amount. (However, the user fee check or money order should not be attached to the Form 2553, Election by a Small Business Corporation, when it is filed at the Service Center. If on the Form 2553 the corporation requests a ruling that it be permitted to use a fiscal year under section 6.03 of Rev. Proc. 87-32, the Service Center will forward such request to the National Office. When the National Office receives the Form 2553 from the Service Center it will notify the taxpayer that the fee is due). Taxpayers should not send cash.

SEC. 3. EFFECT ON OTHER REVENUE PROCEDURES

Sections 4.031 and 4.05 of Rev. Proc. 88-8 are modified.

SEC. 4. EFFECTIVE DATE

This revenue procedure applies to requests postmarked or, if not mailed, received on or after February 1, 1988. This revenue procedure does not apply to requests filed on or after September 30, 1990.

---

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

Rev. Proc. 88-14

CONTENTS

PART A. GENERAL

SECTION 1. PURPOSE
SECTION 2. NATURE OF CHANGES
SECTION 3. DEFINITIONS
SECTION 4. REPORTING SCHEDULES/TRANSMITTAL FORMS
SECTION 5. SUBMISSION DATES OF MAGNETIC TAPES
SECTION 6. INTERNAL REVENUE PROCESSING OF MAGNETIC TAPES
SECTION 7. PRE-OFFSET ADDRESS REQUEST PROCESSING

SECTION 8. ANNUAL DEBTOR MASTER FILE PROCESSING
SECTION 9. AGENCY ADDRESS FILE PROCESSING
SECTION 10. WEEKLY DEBTOR MASTER FILE PROCESSING
SECTION 11. PROBLEM RESOLUTION CONTACTS
SECTION 12. DISCLOSURE & SAFEGUARD REQUIREMENTS

PART B. MAGNETIC TAPE SPECIFICATIONS
SECTION 1. INTRODUCTION
SECTION 2. TAPE AND FILE SPECIFICATIONS
SECTION 3. LOGICAL SEQUENCE OF FILES
SECTION 4. RESERVED
SECTION 5. TRANSMITTER-ANNUAL PRE-OFFSET ADDRESS REQUEST RECORD
SECTION 6. TRANSMITTER-ANNUAL PRE-OFFSET DATA CONTROL RECORD
SECTION 7. SERVICE-ANNUAL PRE-OFFSET UNPROCESSABLE RECORDS
SECTION 8. SERVICE-ANNUAL PRE-OFFSET ADDRESS REQUEST RECORD
SECTION 9. SERVICE-ANNUAL PRE-OFFSET DATA CONTROL RECORD
SECTION 10. TRANSMITTER-ANNUAL CERTIFICATION RECORD
SECTION 11. TRANSMITTER-ANNUAL CERTIFICATION DATA CONTROL RECORD
SECTION 12. SERVICE-ANNUAL UNPROCESSABLE CERTIFICATION RECORD
SECTION 13. SERVICE-ANNUAL NO MATCH RECORD
SECTION 14. SERVICE-ANNUAL NO MATCH DATA CONTROL RECORD
SECTION 15. TRANSMITTER-AGENCY ADDRESS RECORD
SECTION 16. TRANSMITTER-AGENCY ADDRESS DATA CONTROL RECORD
SECTION 17. TRANSMITTER-WEEKLY UPDATE RECORD
SECTION 18. TRANSMITTER-WEEKLY UPDATE DATA CONTROL RECORD
SECTION 19. SERVICE-WEEKLY UNPROCESSABLE UPDATE RECORD
SECTION 20. SERVICE-WEEKLY COLLECTION (OFFSET/CLAIM) RECORD
SECTION 21. SERVICE-WEEKLY COLLECTION (OFFSET/CLAIM) DATA CONTROL RECORD
SECTION 22. TRANSMITTER-HEADER RECORD
SECTION 23. SERVICE-HEADER RECORD

PART A. GENERAL

SECTION 1. PURPOSE

.01 The purpose of this Revenue Procedure is to provide the requirements and conditions for filing pre-offset address request, annual certification, weekly update and agency address records on magnetic tape of federal debts which are eligible for the Federal Income Tax Refund Offset Program. This Revenue Procedure is issued under the Tax Refund Offset Program. This Revenue Procedure is issued under the authority contained in Section 7805 of the Internal Revenue Code of 1986 and in Section 3720A of Subchapter 37 of Title 31 United States Code. See Exhibit A.1-1 for overview of project.

.02 Included in this Revenue Procedure are requirements for:

(a) submitting Pre-Offset Address Request records to secure the address from the taxpayer's latest income tax return to be used by the agency whe notifying a taxpayer of a potential offset.

(b) submitting Annual Certification records for inclusion on the Debtor Master File.

(c) submitting Federal Agency's addresses and contacts on magnetic tape for inclusion on IRS offset notices to taxpayers.

(d) submitting Weekly Updates to 1) delete or decrease a previously certified debt or 2) indicate that the federal agency has refunded a previous federal income tax refund offset to a taxpayer.

.03 The Internal Revenue Service (IRS), upon receipt of Annual Certification records, will mark matching individual taxpayer accounts to prohibit refunding of overpayments to the taxpayer. When refundable credits (usually resultant from the filing of a current year tax return) are processed, an offset record is generated to the agency for the amount of obligation or the amount of the refund, whichever is less. This offset record will also reflect current taxpayer identifying information valid for the offset tax year, *i.e.*, SSN, name(s), and current address. Claims may be filed by an "injured spouse" to recover their portion of any joint overpayment which is not subject to offset by submitting Form 1040X and Form 8379.

.04 See Section 12 Part A for Information regarding Safeguards and Procedures.

.05 Specifications for the following agency submitted records are contained in this Revenue Procedure:

(a) Transmitter-Annual Pre-Offset Address Request Record

(b) Transmitter-Annual Pre-Offset Data Control Record

(c) Transmitter-Annual Certification Record

(d) Transmitter-Annual Certification Data Control Record

(e) Transmitter-Agency Address Record

(f) Transmitter-Agency Address Data Control Record

(g) Transmitter-Weekly Update Record

(h) Transmitter-Weekly Update Data Control Record

.06 Specifications for the following IRS records returned to the Federal Agency are contained in this Revenue Procedure:

(a) Service-Annual Pre-Offset Unprocessable Record

(b) Service-Annual Pre-Offset Address Request Record

(c) Service-Annual Pre-Offset Data Control Record

(d) Service-Annual Unprocessable Certification Record

(e) Service-Annual No Match Record

(f) Service-Annual No Match Data Control Record

(g) Service-Weekly Unprocessable Update Record

(h) Service-Weekly Collection (Offset/Claim) Record

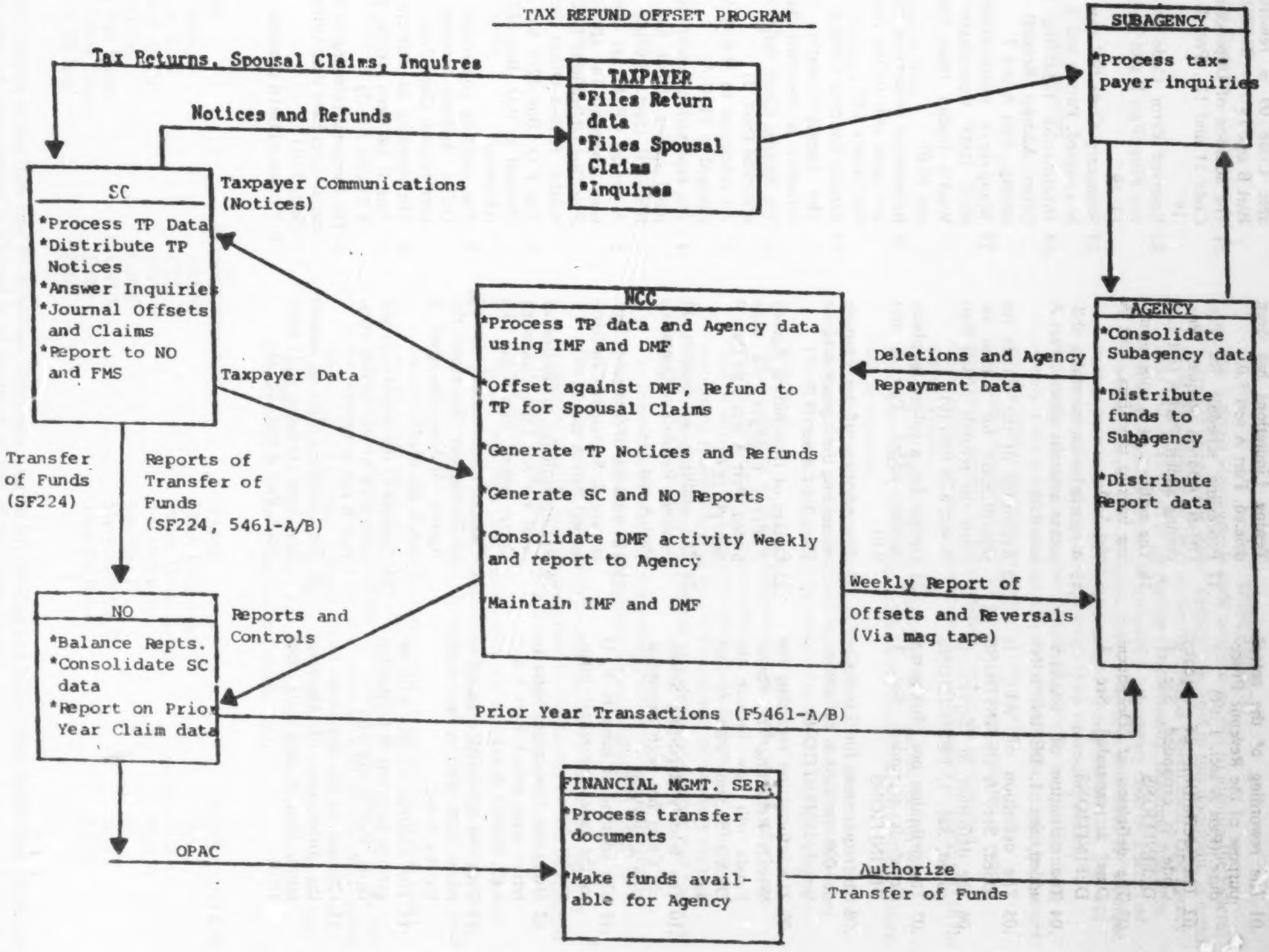
(i) Service-Weekly Collection (Offset/Claim) Data Control Record

.07 Specifications for Header records are contained in Section 22 for Transmitter files and Section 23 for IRS files.

Exhibit A.1-1

WEEKLY PROCESSING

TAX REFUND OFFSET PROGRAM


Tax Returns, Spousal Claims, Inquires
Notices and Refunds
TAXPAYER
*Files Return data
*Files Spousal Claims
*Inquires
SUBAGENCY
*Process taxpayer inquiries
SC
*Process TP Data
*Distribute TP Notices
*Answer Inquiries
*Journal Offsets and Claims
*Report to NO and FMS
Taxpayer Communications (Notices)
Taxpayer Data
NCC
*Process TP data and Agency data using IMF and DMF
*Offset against DMF, Refund to TP for Spousal Claims
*Generate TP Notices and Refunds
*Generate SC and NO Reports
*Consolidate DMF activity Weekly and report to Agency
*Maintain IMF and DMF
AGENCY
*Consolidate Subagency data
*Distribute funds to Subagency
*Distribute Report data
Deletions and Agency Repayment Data
Weekly Report of Offsets and Reversals (Via mag tape)
Transfer of Funds (SF224)
Reports of Transfer of Funds (SF224, 5461-A/B)
NO
*Balance Repts.
*Consolidate SC data
*Report on Prior Year Claim data
Reports and Controls
Prior Year Transactions (F5461-A/B)
OPAC
FINANCIAL MGMT. SER.
*Process transfer documents
*Make funds available for Agency
Authorize Transfer of Funds

SEC. 2. NATURE OF CHANGES

.01 The rewording of the actual purpose of the Revenue Procedure. (Part A sect. 1 .01)

.02 The definition of 'Agency Code' is expanded, Sec. 3, DEFINITIONS

.03 The definition of 'Delinquent Date' is expanded, Sec. 3, DEFINITIONS

.04 The definition of 'GOALS' added, Sec. 3, DEFINITIONS

.05 The definition of 'ALC' is added, Sec. 3, DEFINITIONS

.06 The definition of 'Service' is added, Sec. 3, DEFINITIONS

.07 The definition oof 'Subagency Code' is expanded, Sec. 3, DEFINITIONS

.08 The requirement for 'Local Code' 000 specified in definition., Sec. 3, DEFINITIONS

.09 The information regarding the Weekly Reporting/Transfer of Funds will now include the OPAQ System, Part A Sect 4.01

.10 The Weekly Reporting Schedule Chart has been expanded. Part A sect 4.01

.11 The addition of items E, F, G to the tape transmittal form, exhibit A.4-2

.12 Using the Transmittal letter to return tapes added. Part A sect 4.03, Exhibit A.4-1

.13 Required information added to Form 3220. Part A sect 4.03, Exhibit A.4-2

.14 The addition of sect 4.05 regarding shipment of production tapes, Part A sect 4.05

.15 Changes to the due dates for the Submission of Magnetic tapes, Part A sect 5.02, sect 10.01

.16 The information regarding Testing Limitations has been deleted, Part A sect 5.03

.17 Processing schedule for Pre-Offset Address Request Processing added, Part A sect 5.03

.18 The addition of a note regarding backup tape files, Part A sect 5.05

.19 A restriction on increasing obligation amounts added., Part A sect 8.05

.20 Rewording of the criteria for prioritization for federal income tax refunds offset, Part A sect 8.06 item (b)

.21 Option for a collect telephone number added. Part A sect 9.01

.22 The addition of an example referencing the Agency Address File., Part A sect 9.01

.23 Option of transmitting Agency Address changes via tape added. Part A sect 9.04 Part B Sect 15, 22.02

.24 The addition of Section 11 Problem Resolution Contacts., Part A sect 11

.25 The addition of Section 12 Disclosure & Safeguards Requirements, Part A sect 12

.26 Requirement for submission of tapes via one Data Processing Center added., Part B sect 1.02

.27 Changes to the record size of all Transmitter files except the Agency Address file, Part B sect 2 .07, 17, 18

.28 Changes to the record sizes and blocksizes of all Service files, Part B sect 2 .08,19

.29 File Identifiers (data set names) have been expanded to 17 positions. Part B sect .22, 23

.30 The definition of Unprocessable Code 09 is reworded., Part B sect 19

.31 The addition of Unprocessable Code 11 and 12., Part B sect .19

.32 Reserved Error Code on Service Files. Part B sect 7, 8, 12, 13, 19

.33 Subagency Code '99' can now be assigned. Part A sect 3

.34 Information regarding Pre-Offset Address Request Processing., Part A sect 7

.35 Mandatory notification to NCC DMF Coordinator for Weekly Update tapes Part A sect 10.07

.36 Information concerning Service test tapes sent to the Agency, Part A sect 5.02

.37 Various Editorial Changes

.1 The Agency Location Code definition is reworded (Sect.3)

.2 The Spousal Claim definition is reworded (Sect. 3)

.3 All references to D:R:R:A are changed to TR:R:A.

.4 The explanation concerning injured spouse claims has been reworded. (Sect. 10.05(a))

.5 A revised CP 47 has been issued (Overpaid Tax applied to Past-Due Obligation). (Sect. 10 exhibit A.10-4-Offset Notice)

.6 The P.O. Box 1208 has been changed to P.O. Box 887 (All references)

.7 The wording concerning Pre-Offset Address Request has been revised. (Sect. 7.01)

.8 The wording in reference to Item C has been revised. (Sect. 4 Exhibit A.4-2)

.9 The footnotes referring to transmittal dates have been corrected. (Sect. 5.01)

.10 Various editorial changes.

SEC. 3. DEFINITIONS

ELEMENT	DESCRIPTION
Agency Code	This is a two digit numeric code assigned by IRS to identify the Federal Agency involved. The term "agency", as used in this document, is meant to be the Department level within the Federal Government. One agency code will be assigned to an Agency (Department). Different functions within a Department may be assigned a sub-agency code or a series of sub-agency codes (see definition below). Records submitted for a unique agency code must be consolidated prior to being sent to IRS. IRS will return consolidated records to a single Data Processing center.
Agency Case Number	This is the identifying number of the obligor's file at the submitting agency. Field is optional. Use is recommended when an agency does not use the SSN as the primary account/case number.
ALC	An Agency Location Code is a unique identifier assigned to every government agency for the purpose of reporting receipts and disbursements for each agency. An ALC is necessary to participate in the OPAC system.
Delinquent Date	Date the obligation became delinquent. Certification records with a delinquent date 10 yrs old or more by the first offset cycle effective date, will be returned.
DMF Account	A record that has been created as a result of certification by a federal agency's claim that has matched an account on the Individual Master File. This record consists of an entity section and at least one agency subsection.
File	For the purpose of this revenue procedure, a file consists of all tape records submitted by a Transmitter.
GOALS	The Government On-Line Accounting Link System is an automated accounting system designed by the Department of Treasury through which federal agencies can transmit and receive accounting and financial data.
IMF	The Individual Master File is a comprehensive file containing entity information and transaction activity for each individual taxpayer account.
Invalid Segment	The portion of the IMF which contains all SSN's which are currently considered invalid. Records submitted for invalid SSN's will be returned to the submitting agency and will not cause a refund freeze or allow a refund offset.
Local Code	This is a three digit code used to associate an Agency Address Record (Agency Name, Address, telephone numbers) with an individual obligor for use on IRS offset notices. A local code of "000" is required for each subagency.
NCC	National Computer Center P.O. Box 1208, Martinsburg, W.Va. 25401, FTS 937-8345 NON-FTS (304) 267-2911 EXT 345
Name Control	When cases (original certifications and updates) are submitted to the IRS for processing, the SSN and Name Control are used for matching against the taxpayer's account. Records that do not match exactly on SSN and Name Control will be returned to the submitting agency. To ensure that submissions are processable, the following examples demonstrate the proper manner to derive the Name Control field.

NAME	NAME CONTROL	NAME	NAME CONTROL
John Brown	BROW	Mark D'Allesandro	DALL
John A. Lee	LEE *	Pedro Torres-Lopes	TORR
James P. En Sr.	EN *	Joe McCarthy	MCCA
John O'Neill	ONEI	Mr. Eng U	U *
Mary Van Buren	VANB	Mary X-Williams	X-WI
John Diben Edetto	DIBE	Juan De Jesus	DEJE
John A. El-Roy	EL-R		

*Name Controls of less than four (4) significant characters must be left justified and blank filled. Embedded blanks are not allowed. A single hyphen is allowed in all but the first digit of the name control.

Obligor	The person against whom a Federal Agency has certified a delinquent debt.
OPAC	The On-Line Payment and Collection System option of GOALS is an automated accounting system used to transfer the funds weekly to the participating agencies.
Service	The Internal Revenue Service.
Special Character	Any character that is not a numeral, a letter or a blank.
Spousal Claim	An amended return filed by a spouse whose share of a joint overpayment was applied to the other spouses debt. The amount of the claim that is allowed will be refunded to the non obligated spouse. The refund will be addressed to both taxpayers.
SSA	Social Security Administration
SSN	Social Security Number assigned by SSA.
Subagency Code	This is a two digit alpha-numeric code assigned by the agency. The agency must consider the types of delinquent accounts an obligor may have. If multiple accounts are present, a separate subagency code must be used to collect each debt. This code may be any alpha numeric combination. Zero is a valid sub-agency code. All subagency codes assigned by an agency must be approved by IRS.
Transmitter	Participating Federal Agencies preparing tape files.

SEC. 4. REPORTING SCHEDULES/TRANSMITTAL FORMS

.01 *Weekly REPORTING/TRANSFER OF ON-Line Payment and Collection System (OPAC) Schedule*—The Debtor Master File Program is a reimburseable program and all participating agencies reimburse the IRS for all administrative costs. This is accomplished through the On-Line Payment and Collection (OPAC) System option on the Government On-Line Accounting Link System (GOALS). The actual transfer of funds in this program is coordinated by the IRS DMF Coordinator, Returns Processing and Accounting Division (TR:R:A), 1111 Constitution Avenue, N.W., Room 7514, Washington, D.C. 20224 (FTS 343-0145; non-FTS (202) 343-0145), and each participating agency.

Each Monday, through the OPAC system, the net collections are transferred from the IRS Clearing Account 20F3879.09 to each agency's ALC number. The money is available as soon as the transfer is effected; however, the agency will not "see" it on OPAC until the next workday as the data base is updated overnight. The IRS provides the agencies with a transaction file containing collection (offset/claim) information in the form of magnetic tapes (Service-Weekly collection (Offset/Claim) File) on a cycle basis. The weekly OPAC transfer of funds should match the amounts contained on the Weekly Collection Tape. The following chart shows each offset cycle (week) and the effective date (transfer of funds) for that cycle. Note that these are all Monday dates. If the dates happen to fall on a holiday, the transfer of funds will take place the next workday. Also included are the due dates for the Weekly Update tapes and approximate shipping dates for the Weekly Unprocessable and Collection files.

SCHEDULE

DATE 1 = Weekly update due date(THURSDAY)
DATE 2 = Approximate shipping date for Unprocessable File(SATURDAY)
DATE 3 = Approximate shipping date for Collection File(THURSDAY)
DATE 4 = Effective date of Offsets(MONDAY)

CYCLE	DATE 1	DATE 2	DATE 3	DATE 4
8805	01/28/88	01/30/88	02/04/88	02/15/88
8806	02/04/88	02/06/88	02/11/88	02/22/88
8807	02/11/88	02/13/88	02/18/88	02/29/88
8808	02/18/88	02/20/88	02/25/88	03/08/88
8809	02/25/88	02/27/88	03/03/88	03/15/88
8810	03/03/88	03/05/88	03/10/88	03/22/88
8811	03/10/88	03/12/88	03/17/88	03/29/88
8812	03/17/88	03/19/88	03/24/88	04/04/88
8813	03/24/88	03/26/88	03/31/88	04/11/88
8814	03/31/88	04/02/88	04/07/88	04/18/88
8815	04/07/88	04/09/88	04/14/88	04/25/88
8816	04/14/88	04/16/88	04/21/88	05/02/88
8817	04/21/88	04/23/88	04/28/88	05/09/88
8818	04/28/88	04/30/88	05/05/88	05/16/88
8819	05/05/88	05/07/88	05/12/88	05/23/88
8820	05/12/88	05/13/88	05/19/88	05/30/88
8821	05/19/88	05/21/88	05/26/88	06/06/88
8822	05/26/88	05/28/88	06/01/88	06/13/88
8823	06/02/88	06/04/88	06/09/88	06/20/88
8824	06/09/88	06/11/88	06/16/88	06/27/88
8825	06/16/88	06/18/88	06/23/88	07/04/88
8826	06/23/88	06/25/88	60/30/88	07/11/88
8827	07/30/88	07/02/88	07/07/88	07/18/88
8828	07/07/88	07/09/88	07/14/88	07/25/88
8829	07/14/88	07/16/88	07/21/88	08/01/88
8830	07/21/88	07/23/88	07/28/88	08/08/88
8831	07/28/88	07/30/88	08/04/88	08/15/88
8832	08/04/88	08/06/88	08/11/88	08/22/88
8833	08/11/88	08/13/88	08/18/88	08/29/88
8834	08/18/88	08/20/88	08/25/88	09/05/88
8835	08/25/88	08/27/88	09/01/88	09/12/88
8836	09/01/88	09/03/88	09/08/88	09/19/88
8837	09/08/88	09/10/88	09/15/88	09/26/88
8838	09/15/88	09/17/88	09/22/88	10/03/88
8839	09/22/88	09/24/88	09/29/88	10/10/88
8840	09/29/88	10/01/88	10/06/88	10/17/88
8841	10/06/88	10/08/88	10/13/88	10/24/88
8842	10/13/88	10/15/88	10/20/88	10/31/88
8843	10/20/88	10/22/88	10/27/88	11/07/88
8844	10/27/88	10/29/88	11/02/88	11/14/88
8845	11/03/88	11/05/88	11/10/88	11/21/88
8846	11/10/88	11/12/88	11/17/88	11/28/88
8847	11/17/88	11/19/88	11/24/88	12/05/88
8848	11/24/88	11/26/88	12/01/88	12/12/88
8849	12/01/88	12/03/88	12/08/88	12/19/88
8850	12/08/88	12/10/88	12/15/88	12/26/88
8851	12/15/88	12/17/88	12/22/88	01/02/89
8852	12/22/88	12/24/88	12/29/88	01/09/89

.02 WEEKLY UPDATE SCHEDULE—Each agency may submit weekly update information to either delete or decrease an obligation amount or to indicate an agency refund/repayment has been made. These tapes must be received by the National Computer Center no later than Thursday night of each week in order to meet NCC's weekly update cycle. Any tape received after this time may not be input until the following week. IRS will return any records found unprocessable to the participating agency within seven days. NOTE: Agencies must send weekly updates as timely as possible to prevent erroneous offsets or refunds from occurring.

TYPE OF DATE	RUN TITLE	FILE NAME
Pre-Offset Address Request Records	440-03 Annual Pre-Offset	440-PO-##
Annual Certification Records	440-03 Annual	440-AC-##
Agency Address Records	440-20 Agency Address	440-AA-##
Weekly Update Records	445-12 Weekly	445-WK-##

.03 TRANSMITTAL LETTER—Tapes submitted to IRS must be accompanied by a letter as detailed in Exhibit A.4-1 in Part A, Section 4.05 below. Use the following chart to determine run title and file name. The symbol ## in the file name is replaced with your agency code (*i.e.*, 01) as assigned by IRS.

IRS will acknowledge receipt of Agency tapes by returning a signed copy of the transmittal letter. If the Agency does not receive the acknowledgment within one week, they must contact the NCC Debtor Master File Coordinator at FTS 937-8345 (NON-FTS (304) 267-2911 EXT 345) to verify receipt of tape. NOTE: For tapes being returned to NCC (not an agency generated production or test file) please mark the transmittal "returned".

.04 TAPE TRANSMITTAL FORM—IRS/NCC will supply each agency with pre-printed forms (Form 3220) to be completed and shipped along with each tape file sent to IRS. Do not ship tapes and transmittal documents separately. This form is in addition to the Transmittal Letter outlined in Part A, Section 4.03 above. This transmittal form will be supplied for use with the TRANSMITTER—WEEKLY UPDATE PRODUCTION file only. See Exhibit A.4-2 in Part A, Sec. 4.05 below.

.05 Upon Shipment of Production tapes, the Debtor Master File Coordinator at the IRS National Computer Center must be notified on FTS 937-8345 (NON-FTS (304) 267-2911 EXT 345). Please limit these calls to Monday through Friday between the hours of 8:00 AM and 4:00 PM (Eastern Time).

.06 EXPRESS MAIL—ALL TAPES SENT TO NCC MUST USE EXPRESS MAIL NEXT DAY SERVICE (USPS). Any deviations regarding tape shipment must be coordinated with the DMF COORDINATOR AT THE NCC ON FTS 937-8345 (NON-FTS (304)- 267-2911 EXT 345). Please limit these calls to Monday through Friday between the hours of 8:00 AM and 4:00 PM (Eastern Time).

EXHIBIT A.4-1 - TRANSMITTAL LETTER

Submitting Agency
Address
Telephone Number
Agency Code ##
Date

Internal Revenue Service
National Computer Center
P.O. Box 1208
Martinsburg, W.Va. 25401

Attention Debtor Master File Coordinator:

Enclosed please find a tape for the IRS Tax Refund Offset Project for submission to the DMF (select run title from Section 4.03 above) Run.

File Name: (select from Sec. 4.03 above)
Number of Records: ____________
Tape Number: ____________
Number of Blocks: ____________

CIRCLE EACH WHICH IS APPLICABLE

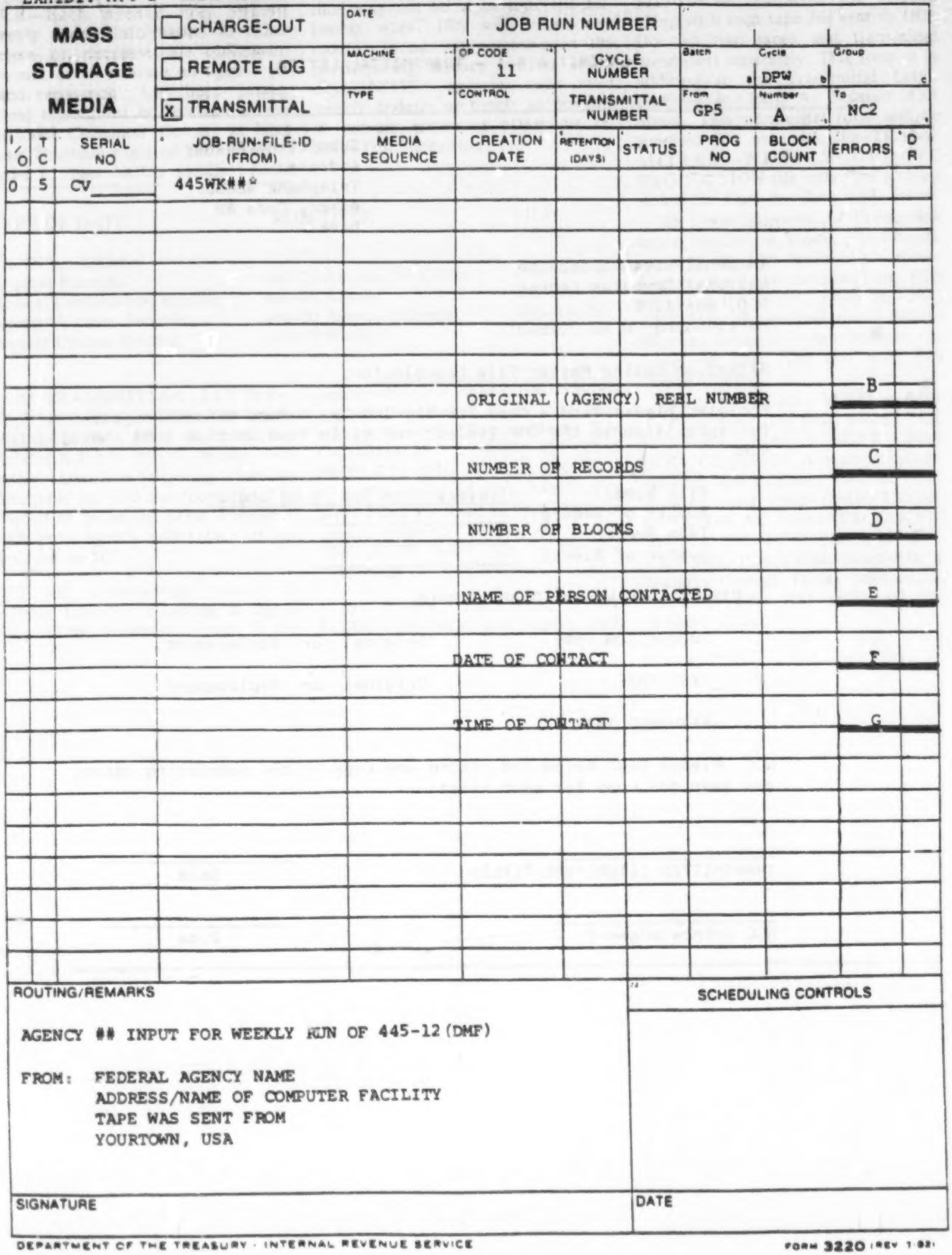
PRODUCTION TAPE	Original	or	Replacement
TEST TAPE	Original	or	Replacement
RETURNED TAPE			

NCC: Please sign below and return one copy to the submitting agency and keep one copy for your files.

____________ ____________
TRANSMITTER (SIGNATURE/TITLE) Date

____________ ____________
NCC Acknowledgment Date

EXHIBIT A.4-2 TAPE TRANSMITTAL FORM 3220



MASS STORAGE MEDIA	☐ CHARGE-OUT	DATE	JOB RUN NUMBER				
	☐ REMOTE LOG	MACHINE	OP CODE 11	CYCLE NUMBER	Batch	Cycle DPW	Group
	☒ TRANSMITTAL	TYPE	CONTROL	TRANSMITTAL NUMBER	From GP5	Number A	To NC2

I/O	TC	SERIAL NO	JOB-RUN-FILE-ID (FROM)	MEDIA SEQUENCE	CREATION DATE	RETENTION (DAYS)	STATUS	PROG NO	BLOCK COUNT	ERRORS	DR
0	5	CV____	445WK##*								

ORIGINAL (AGENCY) REEL NUMBER ____B

NUMBER OF RECORDS ____C

NUMBER OF BLOCKS ____D

NAME OF PERSON CONTACTED ____E

DATE OF CONTACT ____F

TIME OF CONTACT ____G

ROUTING/REMARKS

AGENCY ## INPUT FOR WEEKLY RUN OF 445-12 (DMF)

FROM: FEDERAL AGENCY NAME
ADDRESS/NAME OF COMPUTER FACILITY
TAPE WAS SENT FROM
YOURTOWN, USA

SCHEDULING CONTROLS

SIGNATURE

DATE

DEPARTMENT OF THE TREASURY · INTERNAL REVENUE SERVICE

FORM 3220 (REV. 7-82)

EXHIBIT A.4-2—TAPE TRANSMITTAL FORM 3220 CON'T

Four items must be filled in prior to shipping a tape file:

Item A insert a Transmittal Number here. This number can be used as reference when calling NCC to verify receipt of tapes.

Item B insert original reel number. (Upon receipt, NCC will assign a number of its own under Serial No.)

Item C insert number of records on the file. This should include data records only.

Item D insert number of data blocks on the file.

Item E insert name of Person contacted at NCC regarding shipment of this tape.

Item F insert date of contact in item E.

Item G insert time of contact in item E.

Additional notes for Form 3220

The ## symbols will be the actual agency code assigned by IRS.

A unique number for each agency will be assigned and placed in box 17.

* NCC may add a 2 or 3 digit literal to the file I.D. for each agency.

SEC. 5. SUBMISSION DATES FOR MAGNETIC TAPES

.01 IRS requires participating agencies to provide test tapes for the purpose of compatibility testing as soon as possible after July 1. Tapes must be mailed to:

Internal Revenue Service
National Computer Center
P.O. Box 887
Martinsburg, West Virginia 25401
ATTN: DEBTOR MASTER FILE COORDINATOR

.02 The following final due dates have been established for the submission of TEST tapes and PRODUCTION tapes. Please note that all tapes must be *received* at NCC no later than the final dates shown below. Submission of tapes prior to these dates is acceptable and encouraged. A TEST tape must be submitted prior to a PRODUCTION tape.

TAPE FILE	FINAL Due Dates for TEST TAPE(s)	PROD TAPE(s)
(a) Transmitter-Annual Pre-Offset Address Request Record Tape	Aug. 1, 1987	Aug. 20, 1987
(b) Transmitter-Annual Certification Record Tape	Nov. 14, 1987	* Jan. 6, 1988
(c) Transmitter Agency Address File Tape or Letter	Dec. 1, 1987	Jan. 13, 1988
(d) Transmitter-Weekly Update Record Tape	Dec. 15, 1987	Starting Jan. 28, 1988 and every Thursday evening thereafter

* If a Transmitter-Annual Certification Record Tape is received after this date, there is no guarantee it will be included in the annual certification processing. If it is not so included, the accounts on those tapes will not be subject to offset for the entire calendar year.

SERVICE TEST TAPES—will be created and sent to the agency approximately one week after the receipt of the agency test tape.

.03 Pre-Offset Address Request processing will begin in July and continue on an "as needed" basis thru August 20, 1987. The agency must schedule their participation with the DMF Project Staff. A minimum of one weeks lead time is required. Tape files are due at NCC by Thursday evening prior to the scheduled cycle. The following is the Pre-Offset Schedule:

SCHEDULE
DATE 1 = Tape Due at National Computer Center (THURSDAY)
DATE 2 = Approximate NCC shipping date of Unprocessable File (SAT.)
DATE 3 = Approximate NCC shipping date of Pre-Offset Address File (THURSDAY)

CYCLE	DATE 1	DATE 2	DATE 3
8726	06/25/87	06/27/87	07/02/87
8728	07/09/87	07/11/87	07/16/87
8730	07/23/87	07/25/87	07/30/87
8732	08/06/87	08/08/87	08/13/87
8734	08/20/87	08/22/87	08/27/87

.04 Upon Shipment of Production Tapes, The Debtor Master File Coordinator at the IRS National Computer Center must be notified ON FTS 937-8345 (NON-FTS (304)-267-2911 EXT 345). Please limit these calls to Monday through Friday between the hours of 8:00 AM and 4:00 PM (Eastern Time).

.05 *BACKUP TAPE FILES*—It is suggested that a backup of the Production Transmitter-Annual Certification Records file be sent to IRS. This will minimize the chance of an agency not being included in the year's certification.

NOTE: A backup tape should be sent for the Annual Certification file only.

SEC. 6. INTERNAL REVENUE PROCESSING OF MAGNETIC TAPES

.01 All tapes submitted must conform exactly to this Revenue Procedure. IF TAPES ARE UNPROCESSABLE, THEY WILL BE RETURNED TO THE SUBMITTING AGENCY FOR CORRECTION AND REPLACEMENT. Files received from agencies that contain any of the following error conditions will be returned in their entirety as unprocessable. The National Computer Center will contact the Agency when an unprocessable file is being returned.

(a) A record contains an invalid money amount field (non-numeric).

(b) The control record does not balance with the data records on count and/or amount.

.02 Each unprocessable record will be returned intact with an error code inserted in the record explaining the reason for its return. Part B Sec. 7, 12 and 19 contain the Unprocessable Record layouts which include explanations for each error code.

SEC. 7. PRE-OFFSET ADDRESS REQUEST PROCESSING

.01 Prior to submission of Annual Certification Records, Federal agencies must obtain the latest IRS address information from an individual's tax account by submitting Annual Pre-Offset Address Request Records to IRS. Transmitter-Annual Pre-Offset Address Request Records must contain all elements as specified in Part B, Sec. 5 & 6 of this Revenue Procedure. Agencies must contact the IRS DMF Program Coordinator, Returns Processing & Accounting Division (TR:R:A), 1111 Constitution Ave., NW, Washington, D.C. 20224, (FTS 343-0147, 48, 49, 50, 52, NON-FTS (202) 343-0147, 48, 49, 50, 52), to schedule their participation in Pre-Offset Processing. This processing will begin in July. Pre-Offset TEST tapes must be received no later than August 1, 1987. Pre-Offset PRODUCTION tapes must be received no later than August 20, 1987, to be included in the last scheduled processing cycle. See exhibits A.7-1 and A.7-2.

The purpose of this processing is to obtain address information for use in making a reasonable attempt to notify the obligor of the agencies intent to refer their case to IRS. A reasonable attempt to notify the debtor means that the Agency may use the address they maintain for the debtor if they believe that to be the most current. However, if the notice comes back undeliverable, then the agency must attempt to notify the debtor at the mailing address obtained from the Service pursuant to section 6103(m)(2) or (m)(4) of the Code. The address used by the agency must have been received from the Service within a period of one year preceding the attempt to notify the debtor.

NOTE: REGARDLESS OF WHICH ADDRESS THE AGENCY PLANS TO USE, PARTICIPATION IN PRE-OFFSET ADDRESS PROCESSING IS MANDATORY.

.02 Upon receipt of a file containing Transmitter-Annual Pre-Offset Address Request Records, IRS will validate all records. Those records deemed unprocessable will be returned to the submitting agency containing all elements as specified in Part B, Sec. 7 of this Revenue Procedure. Processable records will be matched against the Individual Master File (IMF).

.03 Files received from agencies that contain any of the following error conditions will be returned in their entirety as unprocessable. The National Computer Center will contact the Agency when an unprocessable file will be returned.

(a) A record contains an invalid money amount field (non-numeric).

(b) The control record does not balance with the data records on count and/or amount.

.04 Records not matching the IMF on SSN and Name Control will be returned to the submitting agency containing all elements as specified in Part B, Sec. 8 & 9.

.05 Records matching the IMF on SSN but not on Name Control will cause extraction of the name line for the SSN as contained on the IMF. The format of the record returned from IRS is specified in Part B, Sec. 8 & 9.

NOTE: The return by IRS of a name line does NOT imply the SSN is correct and the agency name control field is wrong. The agency MUST examine each of these records manually (*i.e.*, not via a computer program!) to determine if the name line IRS has is truly the obligor the agency is attempting to obtain an address for and subsequently certify for offset. Under NO circumstances may an agency routinely use the name and/or name control supplied by IRS.

.06 Records matching the IMF on both SSN and Name Control will cause extraction of the Street Address, City, State and ZIP Code as contained on the IMF. The format of the record returned from IRS is specified in Part B, Sec. 8 & 9.

.07 Because of the similarity in the Pre-Offset and Annual Certification Process, participation in Pre-Offset will allow Federal Agencies to not only receive obligors addresses but also test and review the condition of their data prior to Annual Certification. The submitting agency will be able to review the Unprocessable and No-Match records prior to Annual Certification. Records failing any validity checks at Annual Certification will result in the loss of a potential offset(s) for that processing year.

.08 Agencies are reminded that using any data provided by IRS for other than this program is a conflict with Disclosure provisions and can result in suspension from the program. See statement in Part A, Sec. 1.04.

PRE-OFFSET PROCESSING

TAX REFUND OFFSET PROGRAM

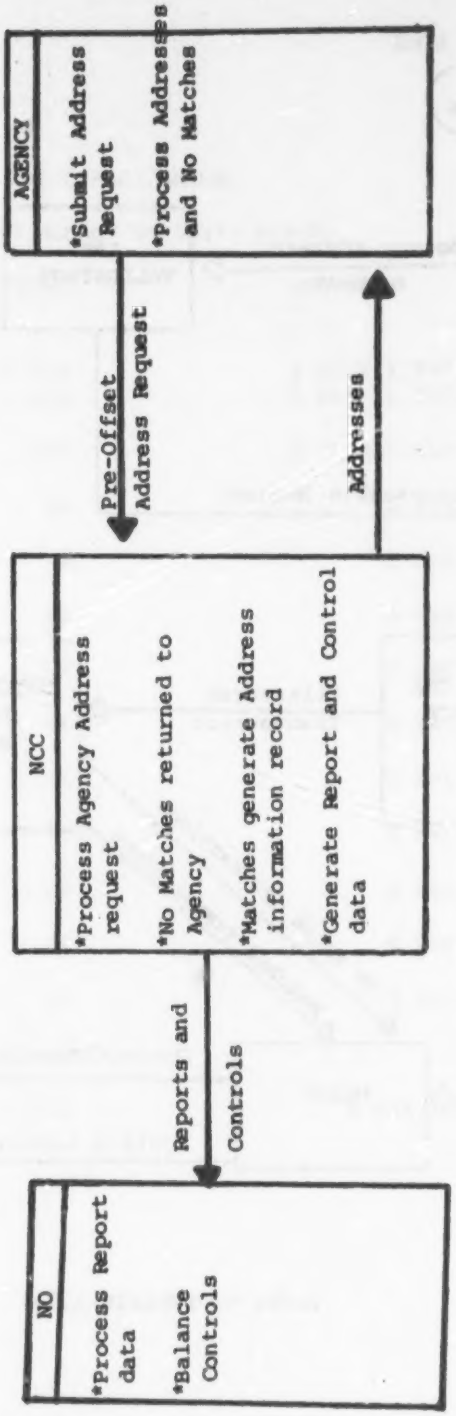
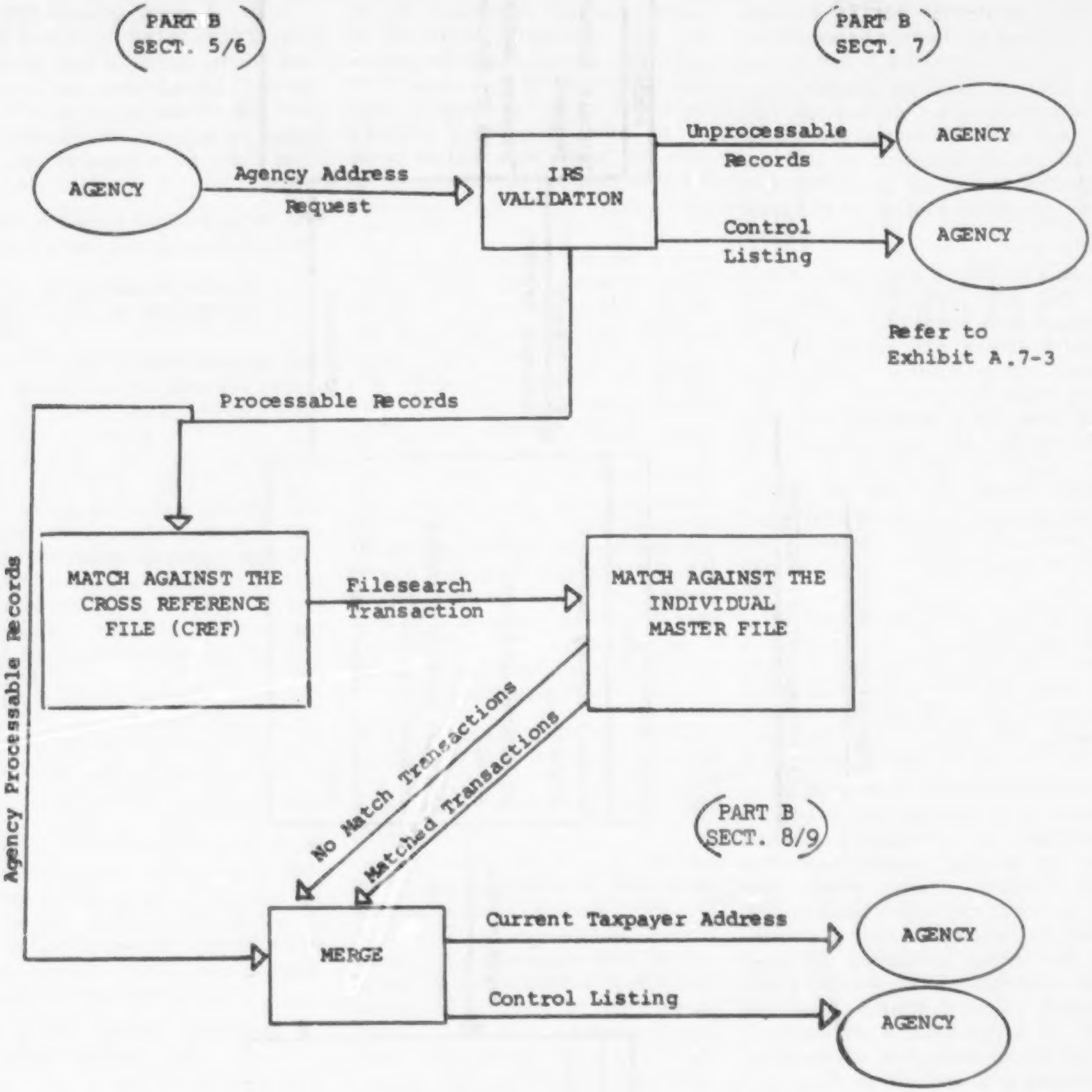

AGENCY
*Submit Address Request
*Process Addresses and No Matches
Pre-Offset Address Request
Addresses
NCC
*Process Agency Address request
*No Matches returned to Agency
*Matches generate Address information record
*Generate Report and Control data
Reports and Controls
NO
*Process Report data
*Balance Controls

EXHIBIT A.7-2

PRE-OFFSET PROCESSING (JULY-OCT)


PART B
SECT. 5/6
PART B
SECT. 7
AGENCY
Agency Address Request
IRS VALIDATION
Unprocessable Records
AGENCY
Control Listing
AGENCY
Processable Records
Agency Processable Records
MATCH AGAINST THE CROSS REFERENCE FILE (CREF)
Filesearch Transaction
MATCH AGAINST THE INDIVIDUAL MASTER FILE
No Match Transactions
Matched Transactions
PART B
SECT. 8/9
MERGE
Current Taxpayer Address
AGENCY
Control Listing
AGENCY

Refer to
Exhibit A.7-3

Refer to Exhibit A.7-4

EXHIBIT A.7.3

```
PROJECT/RUN/FILE  440-03-12
                                                            PAGE

CYCLE   YYCC                                                DATE MMDDYY



                              PRE-OFFSET/ANNUAL

                         (AGENCY) AGENCY VALIDITY REPORT

                              COUNT                AMOUNT


TOTAL RECORDS INPUT           X,XXX                $ XX,XXX,XXX.XX1
VALID RECORDS OUTPUT          X,XXX                $ XX,XXX,XXX.XX

INVAlID RECORDS OUTPUT          XXX                $  X,XXX,XXX.XX

         ERROR CODE  01          XX                        $ XXX.XX

         ERROR CODE  02          XX                        $ XXX.XX

         ERROR CODE  03          XX                        $ XXX.XX

         ERROR CODE  04          XX                        $ XXX.XX

         ERROR CODE  05          XX                        $ XXX.XX

         ERROR CODE  06          XX                        $ XXX.XX

         ERROR CODE  07          XX                        $ XXX.XX

         ERROR CODE  08          XX                        $ XXX.XX

         ERROR CODE  09          XX                        $ XXX.XX

         ERROR CODE  10          XX                        $ XXX.XX

         ERROR CODE  11-15    RESERVED

    TOTAL RECORDS OUTPUT      X,XXX                    $ XXX,XXX.XX
```

EXHIBIT A.7-4

PROJECT/RUN/FILE 440-17-15

CYCLE YYCC

PAGE XX

DATE MM-DD-YY

PREOFFSET
ADDRESS REQUEST
CONTROL LISTING
(AGENCY)

ERROR CODE	NUMBER OF REQUEST	AMOUNT OF OBLIGATION
01	X,XXX	$ X,XXX,XXX.XX
02	X,XXX	$ X,XXX,XXX.XX
03	X,XXX	$ X,XXX,XXX.XX
04-10	RESERVED	
TOTAL	X,XXX	$ X,XXX,XXX.XX

SEC. 8. ANNUAL DEBTOR MASTER FILE PROCESSING

.01 The federal agencies participating in this program must submit their Annual Certification records in accordance with the specifications in Part B, Sec. 10 & 11 of this Revenue Procedure. A TEST tape of Annual Certification records must be received no later than November 14, 1987. The PRODUCTION file must be received no later than January 6, 1988. See exhibits A.8-1, A.8-2.

.02 Upon receipt of a tape containing the Annual Certification records, IRS will validate all records. Those deemed unprocessable will be returned on a separate tape file to the submitting agency containing all elements as specified in Part B, Sec. 12 of this Revenue Procedure including the error reason code. Processable records will be matched against the Individual Master File (IMF).

.03 Tapes received from agencies that contain any of the following error conditions will be returned in their entirety as unprocessable. The National Computer Center will contact the Agency when an unprocessable tape is being returned.

(a) A record contains an invalid money amount field (non-numeric).

(b) The control record does not balance with the data records on count and/or amount.

.04 Those records that do not find a match on the Individual Master File (IMF) will be returned on a separate tape file to the submitting agency containing all elements as specified in Part B, Sec. 13 & 14 of this Revenue Procedure.

.05 Records finding a match on the IMF will create a refund freeze condition. The Debtor Master File (DMF) is initialized annually only from processable certification records that match the IMF. The DMF file can be updated on a weekly basis through offsets and claims from the IMF, and through decreases, deletes and agency refund repayments from the submitting agencies. New accounts cannot be added to the file after the beginning of the calendar year, nor can obligation amounts be increased.

.06 Accounts on the DMF will be prioritized and federal income tax refunds offset based on the following criteria:

(a) Office of Child Support Enforcement (AFDC)—Aid to Families with Dependent Children claims and state foster care and adoption assistance program claims.

(b) All other participating agencies based on the earliest delinquent date. In the event the delinquency date is the same, the account with the larger obligation will be subject to offset first.

(c) Office of Child Support Enforcement (non-AFDC)—NON-Aid to Families with Dependent Children claims.

EXHIBIT A.8-1

ANNUAL PROCESSING

TAX REFUND OFFSET PROGRAM

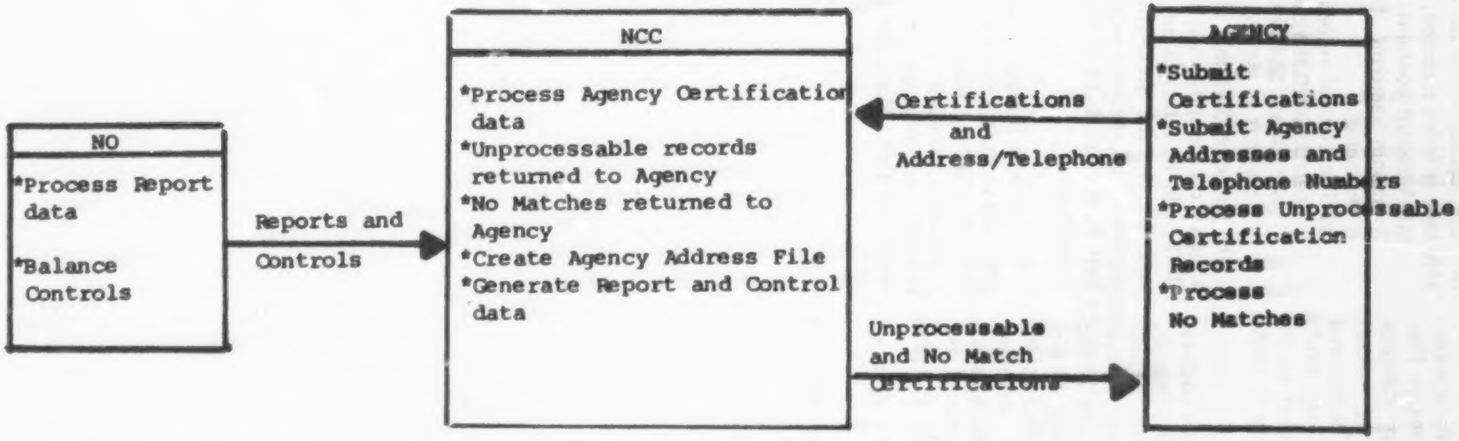
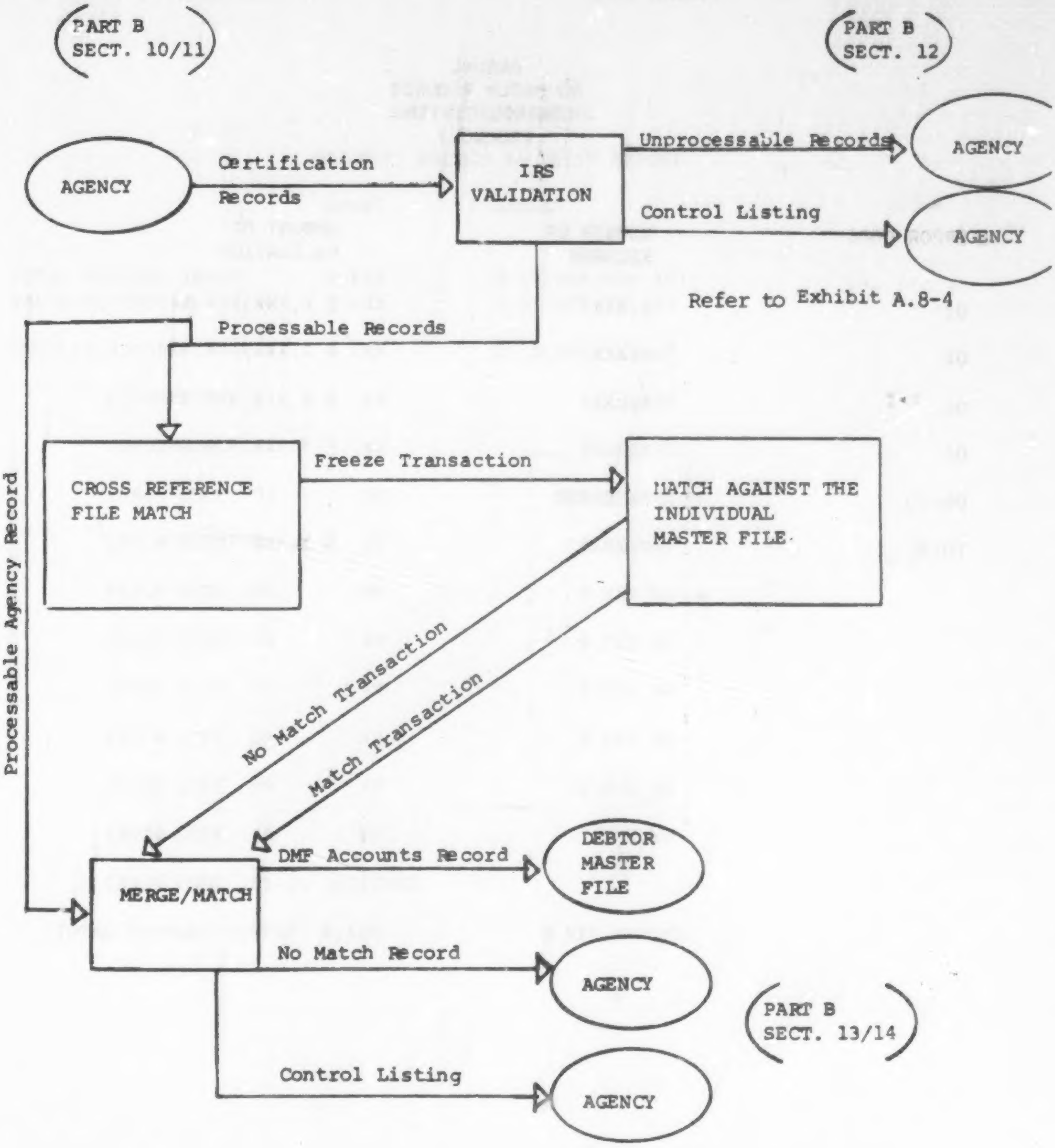

NO
*Process Report data
*Balance Controls
Reports and Controls
NCC
*Process Agency Certification data
*Unprocessable records returned to Agency
*No Matches returned to Agency
*Create Agency Address File
*Generate Report and Control data
Certifications and Address/Telephone
Unprocessable and No Match Certifications
AGENCY
*Submit Certifications
*Submit Agency Addresses and Telephone Numbers
*Process Unprocessable Certification Records
*Process No Matches

EXHIBIT A.8-2

ANNUAL CERTIFICATION (JANUARY)


PART B
SECT. 10/11
PART B
SECT. 12
AGENCY
Certification Records
IRS VALIDATION
Unprocessable Records
AGENCY
Control Listing
AGENCY
Refer to Exhibit A.8-4
Processable Records
Processable Agency Record
CROSS REFERENCE FILE MATCH
Freeze Transaction
MATCH AGAINST THE INDIVIDUAL MASTER FILE
No Match Transaction
Match Transaction
MERGE/MATCH
DMF Accounts Record
DEBTOR MASTER FILE
No Match Record
AGENCY
PART B
SECT. 13/14
Control Listing
AGENCY

Refer to Exhibit A.8-3

EXHIBIT A.8-3

PROJECT/RUN/FILE 440-08-15

CYCLE YYCC

PAGE XX

DATE MM-DD-YY

ANNUAL
NO MATCH RECORDS
CONTROL LISTING
(AGENCY)

ERROR CODE	NUMBER OF RECORDS	AMOUNT OF OBLIGATION
01	X,XXX	$ X,XXX,XXX.XX
02	X,XXX	$ X,XXX,XXX.XX
03	X,XXX	$ X,XXX,XXX.XX
04	X,XXX	$ X,XXX,XXX.XX
05-10	RESERVED	
TOTAL	X,XXX	$ X,XXX,XXX.XX

EXHIBIT A.8-4

```
PROJECT/RUN/FILE   440-03-12

                                                   PAGE


CYCLE    YYCC                                      DATE MMDDYY




                           PRE-OFFSET/ANNUAL

                   (AGENCY) AGENCY VALIDITY REPORT

                          COUNT           AMOUNT



TOTAL RECORDS INPUT       X,XXX         $ XX,XXX,XXX.XX1
VALID RECORDS OUTPUT      X,XXX         $ XX,XXX,XXX.XX

INVALID RECORDS OUTPUT      XXX         $   X,XXX,XXX.XX

           ERROR CODE  01    XX                  $ XXX.XX

           ERROR CODE  02    XX                  $ XXX.XX

           ERROR CODE  03    XX                  $ XXX.XX

           ERROR CODE  04    XX                  $ XXX.XX

           ERROR CODE  05    XX                  $ XXX.XX

           ERROR CODE  06    XX                  $ XXX.XX

           ERROR CODE  07    XX                  $ XXX.XX

           ERROR CODE  08    XX                  $ XXX.XX

           ERROR CODE  09    XX                  $ XXX.XX

           ERROR CODE  10    XX                  $ XXX.XX

           ERROR CODE  11-15 RESERVED

   TOTAL RECORDS OUTPUT  X,XXX               $ XXX,XXX.XX
```

SEC. 9. AGENCY ADDRESS FILE

.01 An Agency Address File will be created annually by IRS and will contain address and contact point information which will be included on all related IRS generated taxpayer correspondences. A central address (local code "000") for each Subagency and at the option of the agency, local addresses (additional local codes), must be provided for inclusion on IRS notices. Agencies will have the ability to correct/update address information throughout the processing year. The first line of the address (Agency Name field) must contain the name of the participating agency (*i.e.*, U.S. Department of Education, Office of Child Support Enforcement, etc.). This field will display as the first address line on the notice the taxpayer receives at the time his refund is offset and must clearly identify which agency has received the collection. (See Example below) No reference will be made to IRS within the Agency Address. At least one address with local code "000" is required for each subagency. See Exhibit A.10-4.

Example: Agency Certification Record:

Obligor = Jane Goodbody
Agency Code = 04
Subagency Code = 22
Local Code = 234

Agency Address Record
Agency Code = 04
Subagency Code = 22
Local Code = 234
Agency Address Info. = Veterans Administration
Regional Off. & Insur. Center
Bishop Henry Whipple Fed. Bld.
P.O. Box 1930
St. Paul, MN 55111.

Agency Phone Info. = 555-1212 (LOCAL)
(814) 555-1212 (Collect)
1-800-626-2912 (Toll Free)
(Nationwide/Toll Free)

When an offset for the above obligor occurs, an offset notice will be generated as in Exhibit A.10.4.

It is required by IRS that the Agency supply at least one toll free or collect telephone number. Space is provided for three phone numbers. More than one toll free or collect number may be used.

NOTE: The telephone number(s) do not have to be different for each local code. The Agency may assign one toll free number for all subagencies.

Initial address information must be submitted on magnetic tape except as noted below. A TEST tape MUST be submitted no later than December 1, 1987. The PRODUCTION tape must be submitted no later than January 13, 1988. All magnetic media address information must conform to the specifications in Part B, Sec. 15 & 16 of this Revenue Procedure.

NOTE: If an Agency has 5 or less Address records, the address information may be submitted via the Updates to Agency Address File procedure as described in 9.02 below.

.02 Updates to Agency Address File VIA Memorandum

Revisions to the Agency Address file submitted at the beginning of the processing year may be submitted whenever necessary. A memorandum must then be mailed to the National Office, Returns Processing & Accounting Division, Attn: Debtor Master File Coordinator, in the format outlined in 9.03 below. Agencies will be notified when the update(s) have been completed. NOTE: Complete address information, including telephone number, must be submitted for all updates (additions and changes).

.03 CHANGE OF ADDRESS LETTER—A memorandum, in the format shown in Exhibit A.9-2 below, must be used to notify IRS of changes or additions to the Agency Address File.

.04 Updates to Agency Address File Via Tape File Revisions to the Agency Address file may be submitted via a tape file. The format is identical to the initial address (Part B, sections 15 & 16) except that the "update indicator" must be appropriately set. A memorandum letter (Exhibit A.9-2) must be submitted to the DMF Coordinator with an attached listing of the address changes on the tape file.

EXHIBIT A.9-1

ADDRESS FILE

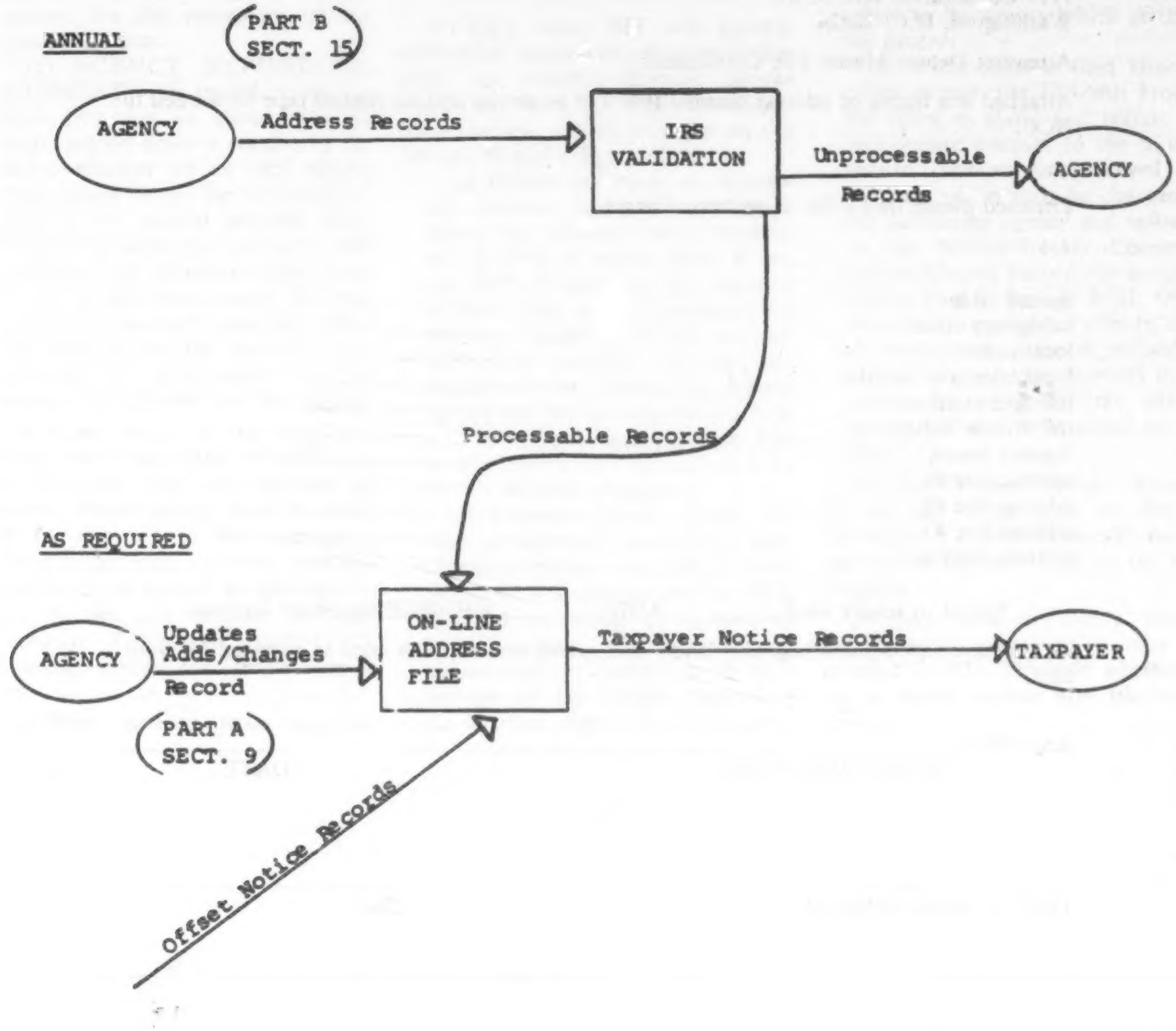

ANNUAL
PART B
SECT. 15
AGENCY
Address Records
IRS
VALIDATION
Unprocessable
Records
AGENCY
Processable Records
AS REQUIRED
AGENCY
Updates
Adds/Changes
Record
ON-LINE
ADDRESS
FILE
Taxpayer Notice Records
TAXPAYER
PART A
SECT. 9
Offset Notice Records

EXHIBIT A.9-2—CHANGE OF ADDRESS LETTER

Submitting Agency
Address
Telephone Number

Internal Revenue Service
Returns Processing & Accounting Division D:R:R:A
Room 7046
1111 Constitution Ave N.W.
Washington, D.C. 20224

Attention Debtor Master File Coordinator:

Attached is a listing of address changes that will be on the address update tape forwarded to NCC.

or

Enclosed please find a list of address changes.

agency code ________
subagency code ________
local code ________
local telephone number ________________
toll free number ________________
toll free or collect ________________
Agency Name ________________
address line #1 ________________
address line #2 ________________
address line #3 ________________
address line #4 ________________

This is to (check one) ________ADD ________CHANGE the above address.

IRS: Please sign acknowledgment below and return one copy. A copy is enclosed for your files.

Requester ________________________________ ____________
SIGNATURE/TITLE DATE

________________________ ________________
TR:R:A Acknowledgment Date

SEC. 10. WEEKLY DEBTOR MASTER FILE PROCESSING

.01 Federal Agencies are encouraged to submit Transmitter Weekly Update Records. These records must be in accordance with specifications in Part B, Sections 17 & 18 of this Revenue Procedure. A TEST file must be received no later than December 15, 1987. PRODUCTION files must be received no later than each THURSDAY night, beginning January 28, 1988, if they are to be timely processed that week. Tapes received later than Thursday will not be processed until the following week. See exhibit A.10-1.

.02 Weekly updates can include the following types of records:

(a) DECREASES—the record used by the submitting agency to reduce a previously certified amount of obligation. IRS will reduce the current amount of obligation by the amount reflected in the DECREASE record. The remaining obligation, when greater than $25.00, will be subject to refund offset whenever credits become available.

(b) DELETES—this record is basically the same as a DECREASE record except that when the amount of decrease is applied to the outstanding obligation amount,

best copy available

as reflected by IRS, the result is $25.00 or less. In this case, IRS will consider the record as a DELETE. A DELETE record must be used whenever a submitting agency intends to eliminate a previously certified case from the DMF.

It should be noted that whenever IRS processes a DELETE record, the obligor will no longer be subjected to the refund offset program for that agency/subagency combination, for the remainder of the processing year.

(c) AGENCY REFUND/REPAYMENT—this record is used to alert IRS that an agency has directly repaid either a portion or the entire amount of an IRS offset. This record should be forwarded to IRS at the earliest possible date. Failure to send this record to IRS whenever this situation arises could result in IRS erroneously allowing an injured spousal claim and billing the agency for the amount. The amount of repayment by the agency is included in the record.

.03 Upon receipt of the tape containing the Transmitter Weekly Update Records, IRS will validate all records. Those deemed unprocessable will be returned to the submitting agency intact with an error code inserted into the record as specified in Part B, Sec. 19 of this Revenue Procedure. Processable records will be used to update the Debtor Master File.

.04 Files received from agencies that contain any of the following error conditions will be returned in their entirety as unprocessable. The National Computer Center will contact the Agency when an unprocessable file is being returned.

(a) A record contains an invalid money amount field (non-numeric).

(b) The control record does not balance with the data records on count and/or amount.

.05 Each week IRS will process individual income tax data including 1040 tax returns, injured spouse claims and other tax related reversals. These actions will be reflected on the Debtor Master File as follows:

(a) Offsets are made on individual income tax return refunds where the taxpayer has a liability on the Debtor Master File. A notice (CP-47) advising the taxpayer of the offset will be generated by IRS (see Exhibit A.10-4). Individual offset records will be sent weekly to the submitting federal agency on the Service-Weekly Collection (Offset/Claim) Record File as specified in Part B, Sec. 20 & 21 of this Revenue Procedure.

(b) Injured spouse claims are filed as amended returns by a non-obligated spouse who files a joint return with a debtor who has been certified for offset by a state or federal agency. The non-obligated spouse may be entitled to all or a portion of the refund, depending on his/her share of the income earned and credits claimed. The claim may be filed at the same time the Federal Income Tax Return is filed in order to receive his/her refund *prior* to offset. However, it may also be filed after the offset has occurred. If the claim is filed with the Federal Income Tax Return, the IRS will process the claim and refund the appropriate amount to the injured spouse. Any remaining overpayment would then be offset to the agency which certified the debtor.

(c) If the claim is filed after an offset occurs, the IRS will process the claim as above and refund the appropriate amount to the injured spouse. The amount allowed (refunded) will in turn be charged to the submitting agency and reflected on the Service-Weekly Collection (Offset/Claim) Record file as specified in Part B, Sec. 20 & 21. Other tax related reversals of offsets, such as bankruptcy cases or erroneous offsets of payments received in response to proposed tax assessments, will also be included on this file.

.06 The Weekly Update Records for the last offset cycle are due on December 22, 1988. This will be the last update file processed for the 1988 program.

.07 Each week the Debtor Master File Coordinator at NCC must be notified on FTS 937-8345 whether or not a weekly update tape has/willbe shipped.

EXHIBIT A-10-1

WEEKLY AGENCY UPDATE (JAN-DEC)

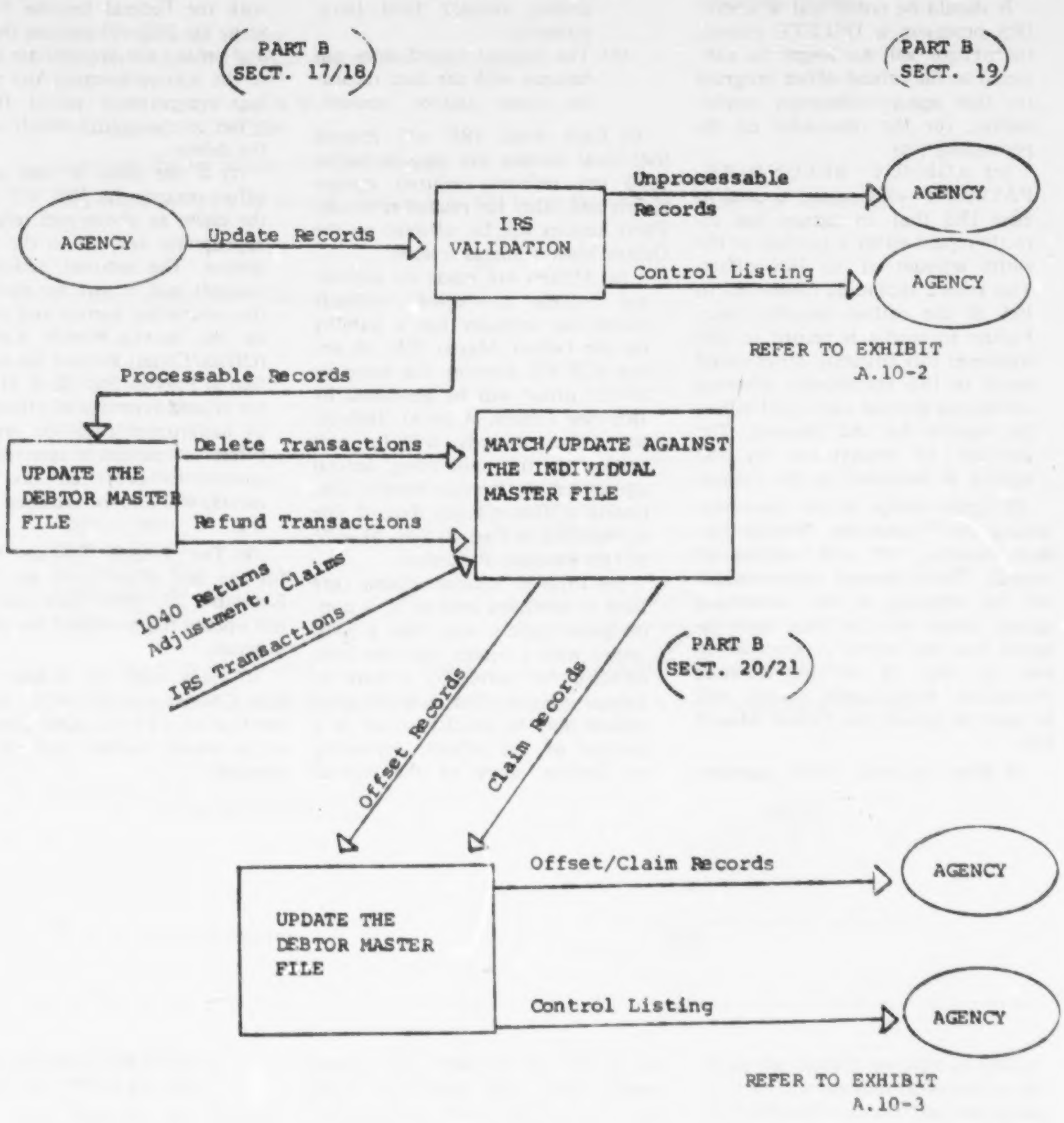

PART B SECT. 17/18
PART B SECT. 19
AGENCY
Update Records
IRS VALIDATION
Unprocessable Records
AGENCY
Control Listing
AGENCY
REFER TO EXHIBIT A.10-2
Processable Records
UPDATE THE DEBTOR MASTER FILE
Delete Transactions
Refund Transactions
MATCH/UPDATE AGAINST THE INDIVIDUAL MASTER FILE
1040 Returns Adjustment, Claims
IRS Transactions
PART B SECT. 20/21
Offset Records
Claim Records
UPDATE THE DEBTOR MASTER FILE
Offset/Claim Records
AGENCY
Control Listing
AGENCY
REFER TO EXHIBIT A.10-3

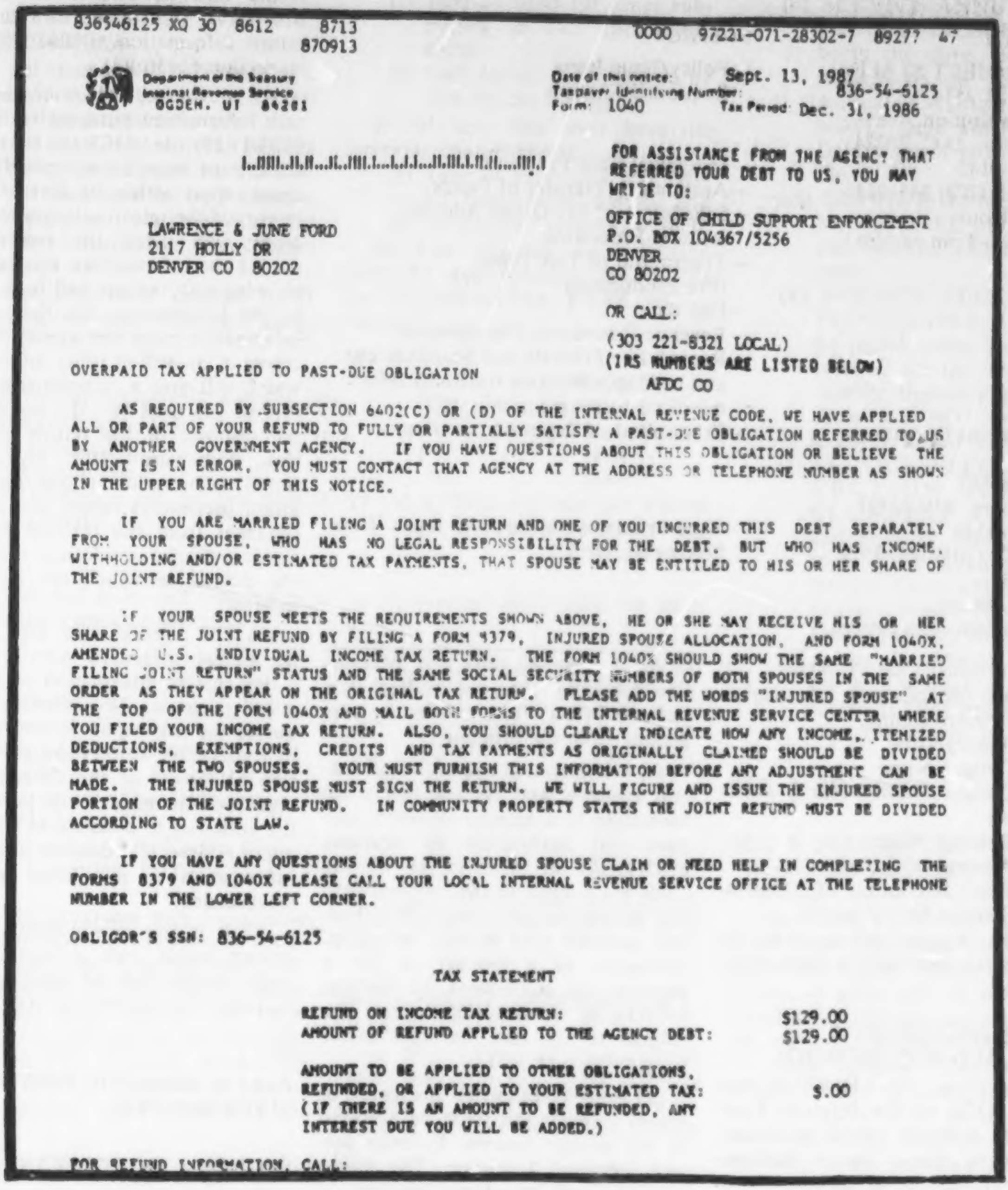
EXHIBIT A.10-2

```
PROJECT/RUN/FILE   445-12-11
                                                  PAGE


CYCLE   YYCC                                      DATE RUN MM-DD-YY



                              IRS DEBTOR MASTER FILE

                          WEEKLY AGENCY VALIDITY LISTING
                                     (AGENCY)

                              COUNT       AMOUNT          COUNT        AMOUNT

TOTAL RECORDS INPUT FILE 445-WK-01                        XX,XXX      $ X,XXX,XXX.XX

PROCESSABLE RECORDS OUT FILE 445-12-11

  DELETES                     X,XXX     $ XX,XXX,XXX.XX

  DECREASES                   X,XXX     $ XX,XXX,XXX.XX

  AGENCY REPAYMENT               XX             $ X.XX

UNPROCESSABLE RECORDS OUT FILE 445-12-12                  XXX         $ XX,XXX.XX

INFORMATION RECORDS OUT FILE 445-12-12                    XXX              $ X.XX

 NO MATCH CODE 01              XXX            $ X.XX

 NO MATCH CODE 02              XXX            $ X.XX

 NO MATCH CODE 03              XXX            $ X.XX

 NO MATCH CODE 04              XXX            $ X.XX

 NO MATCH CODE 05              XXX            $ X.XX

 NO MATCH CODE 06              XXX            $ X.XX

 NO MATCH CODE 07              XXX            $ X.XX

 NO MATCH CODE 08 INFO         XXX            $ X.XX

 NO MATCH CODE 09              XXX            $ X.XX

 NO MATCH CODE 10              XXX            $ X.XX

 NO MATCH CODE 11              XXX            $ X.XX

 NO MATCH CODE 12              XXX            $ X.XX

 NO MATCH CODE 13-20        RESERVED
```

EXHIBIT A.10-3

```
PROJECT/RUN/FILE  445-17-11

CYCLE   YYCC                                                  PAGE   1

                                                              DATE MM-DD-YY


                              WEEKLY AGENCY MERGE REPORT

AGENCY (AGENCY)

                                              CCUNT      AMOUNT

         OFFSETS                              XX,XXX     $ XXX,XXX.XX

         CLAIMS                                  XXX     $ XXX,XXX.XX

         NET COLLECTIONS                      XX,XXX     $ XXX,XXX.XX
```

EXHIBIT A.10-4 - OFFSET NOTICE (CP-47)



836546125 XQ 30 8612 8713
870913

0000 97221-071-28302-7 89277 47

Department of the Treasury
Internal Revenue Service
OGDEN, UT 84201

Date of this notice: Sept. 13, 1987
Taxpayer Identifying Number: 836-54-6125
Form: 1040
Tax Period: Dec. 31, 1986

FOR ASSISTANCE FROM THE AGENCY THAT REFERRED YOUR DEBT TO US, YOU MAY WRITE TO:

OFFICE OF CHILD SUPPORT ENFORCEMENT
P.O. BOX 104367/5256
DENVER
CO 80202

OR CALL:

(303 221-8321 LOCAL)
(IRS NUMBERS ARE LISTED BELOW)
AFDC CO

LAWRENCE & JUNE FORD
2117 HOLLY DR
DENVER CO 80202

OVERPAID TAX APPLIED TO PAST-DUE OBLIGATION

AS REQUIRED BY SUBSECTION 6402(C) OR (D) OF THE INTERNAL REVENUE CODE, WE HAVE APPLIED ALL OR PART OF YOUR REFUND TO FULLY OR PARTIALLY SATISFY A PAST-DUE OBLIGATION REFERRED TO US BY ANOTHER GOVERNMENT AGENCY. IF YOU HAVE QUESTIONS ABOUT THIS OBLIGATION OR BELIEVE THE AMOUNT IS IN ERROR, YOU MUST CONTACT THAT AGENCY AT THE ADDRESS OR TELEPHONE NUMBER AS SHOWN IN THE UPPER RIGHT OF THIS NOTICE.

IF YOU ARE MARRIED FILING A JOINT RETURN AND ONE OF YOU INCURRED THIS DEBT SEPARATELY FROM YOUR SPOUSE, WHO HAS NO LEGAL RESPONSIBILITY FOR THE DEBT, BUT WHO HAS INCOME, WITHHOLDING AND/OR ESTIMATED TAX PAYMENTS, THAT SPOUSE MAY BE ENTITLED TO HIS OR HER SHARE OF THE JOINT REFUND.

IF YOUR SPOUSE MEETS THE REQUIREMENTS SHOWN ABOVE, HE OR SHE MAY RECEIVE HIS OR HER SHARE OF THE JOINT REFUND BY FILING A FORM 8379, INJURED SPOUSE ALLOCATION, AND FORM 1040X, AMENDED U.S. INDIVIDUAL INCOME TAX RETURN. THE FORM 1040X SHOULD SHOW THE SAME "MARRIED FILING JOINT RETURN" STATUS AND THE SAME SOCIAL SECURITY NUMBERS OF BOTH SPOUSES IN THE SAME ORDER AS THEY APPEAR ON THE ORIGINAL TAX RETURN. PLEASE ADD THE WORDS "INJURED SPOUSE" AT THE TOP OF THE FORM 1040X AND MAIL BOTH FORMS TO THE INTERNAL REVENUE SERVICE CENTER WHERE YOU FILED YOUR INCOME TAX RETURN. ALSO, YOU SHOULD CLEARLY INDICATE HOW ANY INCOME, ITEMIZED DEDUCTIONS, EXEMPTIONS, CREDITS AND TAX PAYMENTS AS ORIGINALLY CLAIMED SHOULD BE DIVIDED BETWEEN THE TWO SPOUSES. YOUR MUST FURNISH THIS INFORMATION BEFORE ANY ADJUSTMENT CAN BE MADE. THE INJURED SPOUSE MUST SIGN THE RETURN. WE WILL FIGURE AND ISSUE THE INJURED SPOUSE PORTION OF THE JOINT REFUND. IN COMMUNITY PROPERTY STATES THE JOINT REFUND MUST BE DIVIDED ACCORDING TO STATE LAW.

IF YOU HAVE ANY QUESTIONS ABOUT THE INJURED SPOUSE CLAIM OR NEED HELP IN COMPLETING THE FORMS 8379 AND 1040X PLEASE CALL YOUR LOCAL INTERNAL REVENUE SERVICE OFFICE AT THE TELEPHONE NUMBER IN THE LOWER LEFT CORNER.

OBLIGOR'S SSN: 836-54-6125

TAX STATEMENT

REFUND ON INCOME TAX RETURN:	$129.00
AMOUNT OF REFUND APPLIED TO THE AGENCY DEBT:	$129.00
AMOUNT TO BE APPLIED TO OTHER OBLIGATIONS, REFUNDED, OR APPLIED TO YOUR ESTIMATED TAX: (IF THERE IS AN AMOUNT TO BE REFUNDED, ANY INTEREST DUE YOU WILL BE ADDED.)	$.00

FOR REFUND INFORMATION, CALL:

SEC. 11. PROBLEM RESOLUTION CONTACTS

.01 This section explains the procedures for contacting appropriate IRS personnel. The agency will use the two contact points listed below depending on the nature of the problem or question.

.02 CONTACT POINTS

CONTACT	*SUBJECT*
DMF PROJECT STAFF TR:R:A IR 7514 1111 Constitution Ave Washington, D.C. 20224 FTS 343-0145 NON FTS (202) 343-0145 Contact Hours: Mon-Fri 1-4 pm eastern	—Policy/Issue Items —Requested Changes —Individual Case Problems —Accounting/Transfer of Funds —Scheduling of Pre-Offset Address Request Processing —Transmittal of Test Tapes (Pre-Production) —Due dates —Revenue Procedures Discrepancies —Record/File Formats and Specifications and test tapes (Project staff may refer questions to programming staff.)
NCC Systems Operations Branch P.O. Box 887 Martinsburg, WV 25401 FTS 937-8345 NON FTS (304) 267-2911 EXT 345 Contact Hours: Mon-Fri 8am-4pm eastern	—Transmittal of Tapes (Production) —Tape Problems (replacement tapes, Tape Shipments, etc.)

.03 Individual Case Problems

A. Have the following information available before calling.

1. AgencyName
2. Obligor Name
3. Obligor Social Security Number
4. Date of Offset
5. Amount of Offset
6. Brief description of problem.
7. Spouses SSN if known.

.04 The Agency will provide the DMF Project Staff with a single point of contact.

SEC 12. DISCLOSURE & SAFEGUARD REQUIREMENTS

.01 Sections 6103(1)(10)(b) and 6103(1)(11)(B) of the Internal Revenue Code explicitly restrict participating agencies' use of return information provided in connection with agencies' requests for reductions under IRC 6402(c) and (d). Agencies are permitted to use return information "only for the purpose of, and to the extent necessary in, establishing appropriate agency records or in the defense of any litigation or administrative procedure ensuing from a reduction made under Section 6402(c) or (d)." Agencies using the information for other than the Federal Tax Refund Offset Program can be suspended from the program.

.02 Officers and employees of federal agencies who disclose return information in a manner or for a purpose not authorized by sections 6103(1)(10) or 6103(1)(11) of the Code are subject to the criminal penalty provisions of section 7213. Federal agencies who disclose return information in a manner or for a purpose not authorized by sections 6103(1)(10) or 6103(1)(11) are also subject to the civil damages provisions of section 7431.

.03 Any unauthorized disclosure of return information must be reported to the nearest Internal Revenue Service Regional Inspector. The name, address, and telephone number of this individual may be obtained from the DMF Project Staff.

.04 Return information which is obtained by an agency under sections 6103(1)(10) or 6103(1)(11) of the Code is subject to the safeguard, recordkeeping, and reporting requirements of section 6103(p)(4). If the return information becomes a part of the agency case file regarding a specific taxpayer, the case file must be segregated to the maximum extent possible and safeguarded under the terms and conditions of section 6103(p)(4). Destruction of returns or return information is also governed by section 6103(p)(4).

.05 An agency which receives return information pursuant to sections 6103(1)(10) or 6103(1)(11) of the Code must submit a safeguard procedures report within 30 days of initial receipt of the return information. The report will detail the security accorded the information, the individuals who may request and have access to the information, the flow of the information once the agency has received it, as well as other information which will give a comprehensive picture of the need for, the use of, and the disposal of the return information. Publication 1075 gives additional information about the safeguard procedures report and may be obtained from the Internal Revenue Service district disclosure officer in the district in which the agency is located.

.06 The agency must also submit an annual safeguard activity report giving current information on its safeguard program. The information required for this report is also detailed in Publication 1075. Pursuant to section 6103(p)(4) of the Code and the regulation thereunder, the Service has the authority to conduct its own safeguard reviews if it believes that return information is not being properly safeguarded.

.07 It is the responsibility of any agency which uses a contractor to make certain that all safeguards are in place and utilized by the contractor.

PART B. MAGNETIC TAPE SPECIFICATIONS

SECTION 1. INTRODUCTION

.01 The magnetic tape specifications define the required format and contents of the records to be included in the file. These specifications must be adhered to. Deviations from these requirements must be preapproved by IRS. These specifications are for the participating agency that sends the magnetic tapes to NCC and is not intended to mandate subagency to agency specifications.

.02 IRS will accept tapes from and return tapes to one Data Processing Center for each Agency.

SEC. 2. TAPE AND FILE SPECIFICATIONS

.01 All records will be fixed length and conform to the given Record Specifications provided herein.

.02 All records except the Header and Trailer Labels must be blocked.

.03 All files must be in 9 channel ASCII (American National Standard Code For Information Interchange) with odd parity.

.04 All files must contain ANSI (American National Standard Institute) Header and Trailer Labels. Specific Header Label file information is specified in Part B, Sec. 22 & 23.

.05 Tape Density (BPI) must be as follows:

(a) 1600 or 6250 for tapes submitted to IRS (preferably 6250)

(b) 1600 for all tapes created by IRS for the Agency

.06 All tape files must have the following characteristics:

(a) Type of tape—1/2 inch Mylar base, oxide coated, and

(b) Interblock Gap—3/4 inch.

.07 The logical record size (LRECL) and blocksize (BLKSIZE) for TRANSMITTER FILES are as follows:

FILE	LRECL	BLKSIZE
Annual Pre-Offset Address Request File	150	Note 1
Annual Certification File	150	Note 1
Agency Address File	300	Note 1
Weekly Update File	50	Note 1

Note 1: BLKSIZE can be any multiple of the LRECL but may not exceed 32,000.

.08 The logical record size (LRECL) and blocksize (BLKSIZE) for SERVICE FILES are as follows:

FILE	LRECL	BLKSIZE
Annual Pre-Offset Unprocessable File	150	1950
Annual Pre-Offset Address Request File	215	1935
Annual Unprocessable Certification File	150	1950
Annual No-Match File	185	2035
Weekly Unprocessable Update File	50	2000
Weekly Collection (Offset/Claim) File	250	2000

.09 IRS programs may be capable of accommodating some minor deviations from these specifications. Federal Agencies that do require minor deviations, must contact the DMF Project Coordinator at the National Office on FTS 343-0151 (NON-FTS (202) 343-0151). Tapes from participating agencies will be submitted to:

IRS
National Computer Center
P.O. Box 887
Martinsburg, West Virginia
25401
ATTN: DEBTOR MASTER
FILE COORDINATOR

Under no circumstances may tapes deviating from the specifications in this Revenue Procedure be submitted without prior written approval from IRS.

SEC. 3. LOGICAL SEQUENCE OF FILES

.01 The data on Transmitter FILES may be in any logical sequence as long as the DATA CONTROL record is the very last record of each file.

.02 SERVICE FILES

(a) SERVICE-ANNUAL PRE-OFFSET UNPROCESSABLE FILE will be in the same sequence as received on the Transmitter-Annual Pre-Offset Address Request File. NOTE: there will NOT be a Data Control record on this file.

(b) SERVICE-ANNUAL PRE-OFFSET ADDRESS REQUEST FILE will be in Social Security Number (SSN) order.

(c) SERVICE-ANNUAL UNPROCESSABLE FILE will be in the same sequence as received on the Transmitter-Annual Certification File. NOTE: there will NOT be a Data Control record on this file.

(d) SERVICE-ANNUAL NO MATCH FILE will be in Social Security Number (SSN) order.

(e) SERVICE-WEEKLY UNPROCESSABLE FILE will be in the same sequence as received on the Transmitter-Weekly Update File. NOTE: there will NOT be a Data Control record on this file.

(f) SERVICE-WEEKLY COLLECTION (OFFSET/CLAIM) FILE will be in Social Security Number (SSN) within Subagency order. NOTE: There will be a Data Control record (CNTL) following the data for each Subagency. In addition, there will be a Cumulative Control record (CUM) present as the very last record on the file.

SEC. 4. RESERVED

SEC. 5. TRANSMITTER-ANNUAL PRE-OFFSET ADDRESS REQUEST RECORD

The Annual Pre-Offset Address Request Record contains information on potential obligors. These records are formatted identically to the Annual Certification Record and are used by the agency as a means for obtaining the latest address information and checking status of data. The address will be appended to the end of the incoming record. All records will be returned to the participating agency. ONLY ONE RECORD ALLOWED PER SSN WITH THE SAME AGENCY CODE AND SUBAGENCY CODE. RECORDS WITH THE SAME SSN, AGENCY CODE, SUBAGENCY CODE WILL CAUSE THE FIRST RECORD TO BE ACCEPTED AND THE SUBSEQUENT RECORDS TO BE REJECTED AS DUPLICATES.

RECORD NAME : TRANSMITTER-ANNUAL PRE-OFFSET ADDRESS REQUEST RECORD

Tape Position	Field Title	Length	Description and Remarks
1–2	Agency Code	2	REQUIRED. Code assigned to Agency by IRS
3–4	Subagency Code	2	REQUIRED. Code Assigned by Agency and recognized and approved by IRS. (See Definitions—Part A, Sec. 3)
5	Subagency Priority Code	1	REQUIRED. Indicates subagency with highest priority for OCSE. Must be 0 or 1 for agencies 01 or 02. Zero filled for all other agencies.
6–9	Name Control	4	REQUIRED. Enter the first 4 significant characters of the obligor's last name. Last names of less than four characters must be left justified filling the unused positions with blanks. Embedded blanks must be removed. (See Definitions—Part A, Sec. 3)
10–19	SSN	10	REQUIRED. Enter the obligor's Social Security Number as assigned by SSA. Right justify. The first numeric will be zero.
20–39	Last Name	20	REQUIRED. Enter the obligor's Last Name. Left justify and fill with blanks. It may contain embedded blanks. Hyphens and apostrophes are allowed but no other special characters.
40–54	First Name	15	REQUIRED. Enter the obligor's First Name. Left justify and fill with blanks. It may contain embedded blanks but no numerics. Hyphens are allowed but no other special characters.
55–64	Amount Owed	10	REQUIRED. Enter the amount owed by the obligor. The amount must be entered in dollars and cents. Do not enter dollar signs, commas, decimal points or sign amounts. The Amount Owed must be right justified and unused positions must be zero filled.
65–66	Agency	2	OPTIONAL. For Agency use. If not used, fill with blanks.
67–69	Local Code	3	REQUIRED. FIPS code for OCSE only. Must be numeric. If not available or if agency/subagency has only one Local Code, fill with zeros (See Definitions, Part A, Sec. 3).
70–84	Agency Case Number	15	OPTIONAL. Identifies account for agency files. Use is recommended when an agency does not use the SSN as the primary account/case number. If not used, fill with blanks.
85–86	Filler	2	RESERVED. Fill with Blanks.
87–92	Delinquent Date	6	REQUIRED. The date at which the obligation was delinquent. Format of YYMMDD. Not required for OCSE–zero filled for agencies 01 and 02
93–150	Filler	58	RESERVED. Fill with blanks.

SEC. 6. TRANSMITTER-ANNUAL PRE-OFFSET DATA CONTROL RECORD

Identifies the cumulative counts and amounts for all records on the Transmitter-Annual Pre-Offset tape file. This record must appear as the last data record on the tape file which is submitted to IRS. If the Record Count or Obligation Amount does not balance when the tape is processed, the complete tape file will be rejected, causing that agency not to be able to participate in Pre-Offset.

RECORD NAME : TRANSMITTER-ANNUAL PRE-OFFSET CONTROL RECORD

Tape Position	Field Title	Length	Description and Remarks
1–4	Record ID	4	REQUIRED. Enter the constant "CNTL". This identifies the end of processable records.
5–12	Record Count	8	REQUIRED. Enter record count of Annual Pre-Offset records.
13–24	Obligation Amount	12	REQUIRED. Enter the cumulative total amount for all records, right justified, zero filled.
25–150	Filler	126	REQUIRED. Fill with Blanks.

SEC. 7. SERVICE-ANNUAL PRE-OFFSET UNPROCESSABLE RECORD

Identifies records which were found to be unprocessable during validity processing. All fields remain the same as input on the Transmitter Annual Pre-Offset Address Request Record except in positions 85 & 86 where IRS inserts an error code.

RECORD NAME: SERVICE-ANNUAL PRE-OFFSET UNPROCESSABLE RECORD

Tape Position	Field Title	Length	Description and Remarks
1-2	Agency Code	2	PRESENT. Code assigned to Agency by IRS.
3-4	Subagency Code	2	PRESENT. Code Assigned by Agency and recognized and approved by IRS. (See Definitions, Part A, Sec. 3.)
5	Subagency Priority Code	1	PRESENT. Indicates subagency with highest priority for OCSE. Must be 0 or 1 for agencies 01 or 02. Zero filled for other agencies.
6-9	Name Control	4	PRESENT. The first 4 significant characters of the obligor's last name. Last names of less than four characters will be left justified filling the unused positions with blanks. (See Definitions, Part A, Sec. 3.)
10-19	SSN	10	PRESENT. The obligor's Social Security Number as assigned by SSA. Right justify. The first numeric must be zero.
20-39	Last Name	20	PRESENT. The obligor's Last Name. Left justified and filled with blanks.
40-54	First Name	15	PRESENT. Enter the obligor's First Name. Left justified and filled with blanks. It must not contain any embedded blanks or numerics.
55-64	Amount Owed	10	PRESENT. The amount owed by the obligor. The amount will be entered in dollars and cents. The Amount Owed will be right justified and unused positions must be zero filled.
65-66	Agency Information	2	PRESENT. Information as provided by each agency and approved by IRS.
67-69	Local Code	3	PRESENT. FIPS code used by OCSE. For other agencies as approved by IRS.
70-84	Agency Case Number	15	PRESENT. Identifies account number for agency files. Use is recommended when an agency does not use the SSN as the primary account/case number. If not used, fill with blanks.
85-86	Error Code	2	GENERATE. IRS will insert the appropriate error code: 01-invalid agency code 02-invalid subagency code 03-invalid name control 04-invalid SSN 05-obligation (Amount Owed field) is less than tolerance 06-delinquent date too old 07-invalid delinquent date format 08-priority code not 0 or 1 09-duplicate record (same SSN, agency, and subagency) 10-Last and First Name blank 11-15-RESERVED.
87-92	Delinquent Date	6	PRESENT. The date at which the obligation was delinquent. Format of YYMMDD. Not required for OCSE-zero filled for agencies 01 and 02. No alpha characters allowed.
93-150	FILLER	58	Required. Fill with blanks.

SEC. 8. SERVICE-ANNUAL PRE-OFFSET ADDRESS REQUEST RECORD

This Service Annual Pre-Offset Address Request Record contains address information for all obligor accounts that have been matched to the IMF. The Error Code will be set and the address or nameline may be appended to the end of the incoming record. These records will be returned to the participating agency annually.

RECORD NAME : SERVICE-ANNUAL PRE-OFFSET ADDRESS REQUEST RECORD

Tape Position	Field Title	Length	Description and Remarks
1-2	Agency Code	2	PRESENT. Code assigned to Agency by IRS.
3-4	Subagency Code	2	PRESENT. Code Assigned by Agency and recognized and approved by IRS. (See Definitions, Part A, Sec. 3)
5	Subagency Priority Code	1	PRESENT. Indicates subagency with highest priority for OCSE. Must be 0 or 1 for agencies 01 or 02. Zero filled for all other agencies.
6-9	Name Control	4	PRESENT. Enter the first 4 significant characters of the obligor's last name. Last names of less than four characters should be left justified filling the unused positions with blanks. Embedded blanks must be removed. (See Definitions, Part A, Sec. 3)
10-19	SSN	10	PRESENT. Enter the obligor's Social Security Number as assigned by SSA. Right justify. The first numeric will be zero.
20-39	Last Name	20	PRESENT. Enter the obligor's Last Name as provided by the agency. Left justified and filled with blanks.
40-54	First Name	15	PRESENT. Enter the obligor's First Name as provided by the agency. Left justified and filled with blanks.
55-64	Amount Owed	10	PRESENT. Enter the amount owed by the obligor. The amount must be entered in dollars and cents. Do not enter dollar signs, commas, decimal points or negative amounts. The Amount Owed must be right justified and unused positions must be zero filled.
65-66	Agency Information	2	PRESENT. For use by each agency. If not used, fill with blanks.
67-69	Local Code	3	PRESENT. FIPS code for OCSE. For other agencies, as approved by IRS.
70-84	Agency Case Number	15	PRESENT. Identifies account number for agency files. Use is recommended when an agency does not use the SSN as the primary account/case number. If not used, fill with blanks.
85-86	Error Code	2	GENERATED. IRS will insert the appropriate code from the table below. ERROR CODE — EXPLANATION: 00 — Record matched to IMF, Address information follows. 01 — SSN does not match IMF 02 — SSN matches IMF but Name Control does not match. IMF Nameline data follows. 03 — SSN is listed on invalid segment of the IMF or another condition causes the record to go unpostable. 04-10 — RESERVED.
87-92	Delinquent Date	6	PRESENT. The date at which the obligation was delinquent. Format of YYMMDD. Not required for OCSE-zero filled for agencies 01 and 02.
93-150	FILLER	58	PRESENT. Filled with blanks.
151-185	Street Address/ Name	35	PRESENT. If the Error Code is 00, field contains latest mailing address of obligor. NOTE: The street address may be blank. If the Error Code is 02, the entire name as it appears on the IMF, formatted Last Name, First Name. (Example: Public, John & Mary) will appear in this field. For Error Codes 01 and 03, this field will be filled with blanks.
186-210	City and State	25	PRESENT. The obligor's city and state of residence if the Error Code is 00; otherwise blanked filled. Note: the City/State field may contain City/Country for foreign address.
211-215	ZIP Code	5	PRESENT. The obligor's ZIP Code if the Error Code equals 00; otherwise blanked filled.

SEC. 9. SERVICE-ANNUAL PRE-OFFSET DATA CONTROL RECORD

Identifies the cumulative counts of all matched and unmatched records on IRS Annual Pre-Offset Address Request tape file. This record will appear as the last data record on the tape file that IRS will return to the participating agency.

RECORD NAME : SERVICE-ANNUAL PRE-OFFSET CONTROL RECORD

Tape Position	Field Title	Length	Description and Remarks
1–4	Record ID	4	PRESENT. Enter the constant "CNTL". This identifies the end of processable records.
5–12	Total Match	8	PRESENT. Enter the cumulative record count for all records that have been correctly matched with a corresponding IMF account.
13–20	Total No Match	8	PRESENT. Enter the cumulative record count for all records unable to be correctly matched with a corresponding IMF account.
21–215	Filler	195	PRESENT. Filled with blanks.

SEC. 10. TRANSMITTER-ANNUAL CERTIFICATION RECORD

Records submitted to initialize the Debtor Master File identifying the obligor and amount of obligation. These records are submitted annually by the Agency for each obligor having a delinquent debt to that agency. ONLY ONE RECORD ALLOWED PER SSN WITH THE SAME AGENCY CODE AND SUBAGENCY CODE. RECORDS WITH THE SAME SSN, AGENCY CODE, SUBAGENCY CODE WILL CAUSE THE FIRST RECORD TO BE ACCEPTED AND THE LATER RECORDS TO BE REJECTED AS DUPLICATES.

RECORD NAME : TRANSMITTER-ANNUAL CERTIFICATION RECORD

Tape Position	Field Title	Length	Description and Remarks
1–2	Agency Code	2	REQUIRED. Code assigned to Agency by IRS.
3–4	Subagency Code	2	REQUIRED. Code Assigned by Agency and recognized and approved by IRS. (See Definitions—Part A, Sec. 3)
5	Subagency Priority Code	1	REQUIRED. Indicates subagency with highest priority for OCSE. Must be 0 or 1 for agencies 01 or 02. Zero filled by other agencies.
6–9	Name Control	4	REQUIRED. Enter the first 4 significant characters of the obligor's last name. Last names of less than four characters should be left justified filling the unused positions with blanks. Apostrophes and embedded blanks must be removed, a hyphen is allowed in position 2, 3 or 4. (See Definitions, Part A, Sec. 3)
10–19	SSN	10	REQUIRED. Enter the obligor's Social Security Number as assigned by SSA. Right justify. The first numeric must be zero.
20–39	Last Name	20	REQUIRED. Enter the obligor's Last Name. Left justify and fill with blanks. It may contain embedded blanks. Hyphens and apostrophes are allowed but no other special characters.
40–54	First Name	15	REQUIRED. Enter the obligor's First Name. Left justify and fill with blanks. It may contain embedded blanks but no numerics. Hyphens are allowed but no other special characters.
55–64	Amount Owed	10	REQUIRED. Enter the amount owed by the obligor. The amount must be entered in dollars and cents and must be unsigned. The Amount Owed must be right justified and unused positions must be zero filled. Amount owed may never be less than $25.00. Higher minimum obligation amounts may be assigned by agency and recognized and approved by IRS.
65–66	Agency Information	2	OPTIONAL. For Agency use.
67–69	Local Code	3	REQUIRED. FIPS code for OCSE only. Must be numeric. If not available or if agency/subagency has only one Local Code, fill with zeros. (See Definitions, Part A, Sec. 3)
70–84	Agency Case Number	15	OPTIONAL. Identifies account number for agency files. Use is recommended when an agency does not use the SSN as the primary account/case number. If not used, fill with blanks.

RECORD NAME : TRANSMITTER-ANNUAL CERTIFICATION RECORD—Continued

Tape Position	Field Title	Length	Description and Remarks
85-86	FILLER	2	REQUIRED. Fill with Blanks.
87-92	Delinquent Date	6	REQUIRED. The date at which the obligation was delinquent. Format of YYMMDD. Not required for OCSE-zero filled for agencies 01 and 02. No alpha characters allowed.
93-150	FILLER	58	REQUIRED. Fill with blanks.

SEC. 11. TRANSMITTER-ANNUAL CERTIFICATION DATA CONTROL RECORD

Identifies the cumulative counts and amounts for all records on the Transmitter Annual Certification tape file. This record must appear as the last data record on the tape file which is submitted to IRS. If the Record Count or Obligation Amount does not balance when the tape is processed, the complete tape file will be rejected, potentially resulting in that agency not being able to participate for that year.

RECORD NAME : TRANSMITTER-ANNUAL CERTIFICATION CONTROL RECORD

Tape Position	Field Title	Length	Description and Remarks
1-4	Record ID	4	REQUIRED. Enter the constant "CNTL". This identifies the end of processable records tape file.
5-12	Record Count	8	REQUIRED. Enter the number of Annual Certification records. Right justify and fill with zeroes.
13-24	Obligation Amount	12	REQUIRED. Enter the cumulative total of Amount Owed for all obligors. The amount must be entered in dollars and cents. Do not enter dollar signs, commas, decimal points or negative amounts. The Obligation Amount must be right justified and unused positions must be zero filled.
25-150	Filler	126	RESERVED. Fill with blanks.

SEC. 12. SERVICE-ANNUAL UNPROCESSABLE CERTIFICATION RECORD

Identifies records which were found to be unprocessable during validity processing. All fields remain the same as input on the Transmitter Annual Certification Record except in positions 85 & 86 where IRS inserts an error code.

RECORD NAME : SERVICE-ANNUAL UNPROCESSABLE CERTIFICATION RECORD

Tape Position	Field Title	Length	Description and Remarks
1-2	Agency Code	2	PRESENT. Code assigned to Agency by IRS.
3-4	Subagency Code	2	PRESENT. Code Assigned by Agency and recognized and approved by IRS. (See Definitions—Part A, Sec. 3)
5	Subagency Priority Code	1	PRESENT. Indicates subagency with highest priority for OCSE. Must be 0 or 1 for agencies 01 or 02. Zero filled by other agencies.
6-9	Name Control	4	PRESENT. Enter the first 4 significant characters of the obligor's last name. Last names of less than four characters will be left justified filling the unused positions with blanks. Apostrophes and embedded blanks must be removed, hyphens are allowed in position 2, 3 or 4. (See Definitions—Part A, Sec. 3)
10-19	SSN	10	PRESENT. The obligor's Social Security Number as assigned by SSA. Right justify and first numeric must be zero.
20-39	Last Name	20	PRESENT. The obligor's Last Name. Left justified and filled with blanks. It will contain last name of obligor as submitted by the agency.
40-54	First Name	15	PRESENT. Enter the obligor's First Name. Left justified and filled with blanks. It will contain first name of obligor as submitted by the agency.
55-64	Amount Owed	10	PRESENT. The amount owed by the obligor. The amount will be entered in dollars and cents. The Amount Owed will be right justified and unused positions must be zero filled.
65-66	Agency Information	2	PRESENT. Information as provided by each agency and approved by IRS.

RECORD NAME : SERVICE-ANNUAL UNPROCESSABLE CERTIFICATION RECORD—Continued

Tape Position	Field Title	Length	Description and Remarks
67–69	Local Code	3	PRESENT. FIPS code of OCSE. For other agencies, as approved by IRS.
70–84	Agency Case Number	15	PRESENT. Identifies account number for agency files. Use is recommended when an agency does not use the SSN as the primary account/case number. If not used, fill with blanks.
85–86	Error Code	2	PRESENT. IRS will insert error code which applies: 01–invalid agency code 02–invalid subagency 03–invalid name control 04–invalid SSN 05–obligation(Amount Owed field) less than tolerance 06–delinquent date too old 07–invalid delinquent date format 08–priority code not 0 or 1 09–duplicate record (same SSN, Agency and Subagency 10–Last and First Name Blank 11–15–RESERVED
87–92	Delinquent Rate	6	PRESENT. The date at which the obligation was delinquent. Format of YYMMDD. Not required for OCSE–zero filled for agencies 01 and 02. No alpha characters allowed.
93–150	FILLER	58	PRESENT. Filled with blanks.

SEC. 13. SERVICE-ANNUAL NO MATCH RECORD

Identifies Transmitter Annual Certification Records which do not match the Individual Master File. The explanation for this can be found in the Error Code Field of the record. A fixed field is added to the end of the input record and the IRS Nameline is inserted on all no match code 02 records. All other fields remain the same as input on the Transmitter Annual Certification Record.

RECORD NAME : SERVICE-ANNUAL NO MATCH RECORD

Tape Position	Field Title	Length	Description and Remarks
1–2	Agency Code	2	PRESENT. Code assigned to Agency by IRS.
3–4	Subagency Code	2	PRESENT. Code Assigned by Agency and recognized and approved by IRS. (See Definitions—Part A, Sec. 3)
5	Subagency Priority Code	1	PRESENT. Indicates subagency with highest priority for OCSE. Must be 0 or 1 for agencies 01 or 02. Zero filled by other agencies.
6–9	Name Control	4	PRESENT. Enter the first 4 significant characters of the obligor's last name. Last names of less than four characters will be left justified filling the unused positions with blanks. Apostrophes and embedded blanks will be removed, a hyphen is allowed in position 2, 3 or 4. (See Definitions—Part A, Sec. 3)
10–19	SSN	10	PRESENT. Enter the obligor's Social Security Number as assigned by SSA. Right justify and first numeric will be zero.
20–39	Last Name	20	PRESENT. Enter the obligor's Last Name. Left justified and filled with blanks. It will contain last name of obligor as submitted by the agency.
40–54	First Name	15	PRESENT. The obligor's First Name. Left justified and filled with blanks. It will contain first name of obligor as submitted by the agency.
55–64	Amount Owed	10	PRESENT. The amount owed by the obligor. The amount must be entered in dollars and cents. Do not enter dollar signs, commas, decimal points or negative amounts. The Amount Owed must be right justified and unused positions must be zero filled.
65–66	Agency Information	2	PRESENT. Information as necessary to be determined by each agency and recognized and approved by IRS. If not used, fill with blanks.

RECORD NAME : SERVICE-ANNUAL NO MATCH RECORD—Continued

<table>
<tr><th>Tape Position</th><th>Field Title</th><th>Length</th><th>Description and Remarks</th></tr>
<tr><td>67-69</td><td>Local Code</td><td>3</td><td>PRESENT. FIPS code used by OCSE. For other agencies, as approved by IRS.</td></tr>
<tr><td>70-84</td><td>Agency Case Number</td><td>15</td><td>PRESENT. Identifies account number for the agency files. Use is recommended when an agency does not use the SSN as the primary account/case number. If not used, fill with blanks.</td></tr>
<tr><td>85-86</td><td>Error Code</td><td>2</td><td>PRESENT. The IRS will insert the appropriate code from the table below.
<table>
<tr><th>ERROR CODE</th><th>EXPLANATION</th></tr>
<tr><td>01</td><td>SSN does not match IMF or SSN matches an IMF account that has been merged with or changed from ana ccount with a different SSN.</td></tr>
<tr><td>02</td><td>SSN matches IMF but Name Control does not match.</td></tr>
<tr><td>03</td><td>SSN is listed on the invalid segment of the IMF or another condition causes the record to go unpostable.</td></tr>
<tr><td>04</td><td>SSN matches IMF but Account contains Bankruptcy Freeze.</td></tr>
<tr><td>05-10</td><td>Reserved.</td></tr>
</table></td></tr>
<tr><td>87-92</td><td>Delinquent Date</td><td>6</td><td>PRESENT. The date at which the obligation was delinquent. Format of YYMMDD. Not required for OCSE—zero filled for agencies 01 & 02.</td></tr>
<tr><td>93-150</td><td>FILLER</td><td>58</td><td>PRESENT. Blank-filled.</td></tr>
<tr><td>151-185</td><td>IMF NAME LINE</td><td>35</td><td>PRESENT. Inserted by IRS on all no match code 02. Will be formatted Last name, First name *e.g.*, Public, John & Mary. Field will be blank filled on all other records.</td></tr>
</table>

SEC. 14. SERVICE-ANNUAL NO MATCH DATA CONTROL RECORD

Identifies the cumulative counts and amounts for all records on the Service Annual No Match tape file. This record will appear as the last data record on the tape file that IRS will return to the submitting agency.

RECORD NAME : SERVICE-ANNUAL NO MATCH CONTROL RECORD

Tape Position	Field Title	Length	Description and Remarks
1-4	Record ID	4	PRESENT. The constant "CNTL". This identifies the end of processable records.
5-12	Total No Match	8	PRESENT. The cumulative record count for all obligor SSN's which did not match the IMF. Right justified and filled with zeroes.
13-24	Obligation Amount	12	PRESENT. The cumulative total in Amount Owed for all obligor SSN's which did not match the Individual Master File. The amount will be entered in dollars and cents. No dollar signs, commas, decimal points or negative amounts. The Obligation Amount will be right justified and unused portions will be zero filled.
25-185	Filler	161	PRESENT. Filled with Blanks.

SEC. 15. TRANSMITTER-AGENCY ADDRESS RECORD

The Agency Address Record contains address information which will be included on Service notices to taxpayers. Agencies may submit a central address to refer all obligor inquiries or may submit local addresses.

RECORD NAME : AGENCY ADDRESS RECORD

Tape Position	Field Title	Length	Description and Remarks
1-2	Agency Code	2	REQUIRED. Agency Code as assigned by IRS.

RECORD NAME : AGENCY ADDRESS RECORD—Continued

Tape Position	Field Title	Length	Description and Remarks
3–4	Subagency Code	2	REQUIRED. As assigned by Agency and recognized and approved by IRS. (See Definitions, Part A, Sec. 3)
5–7	Local Code	3	REQUIRED. FIPS code for OCSE only. Must be numeric. At least one local code "000" required for each subagency. (See Definitions, Part A, Sec. 3).
8	CHANGE INDICATOR	1	Blank for Annual Address File. For Change Address File, Values are: C = change address A = add address D = Delete address
9–21	Filler	13	REQUIRED. Blank fill.
22–56	Agency Name	35	REQUIRED. Name of Agency *e.g.*, Department of Education
57–91	Address Line #1	35	REQUIRED. Address Lines 1 through 4 should contain additional address information. Embedded blank lines are not allowed, all lines will be formatted from top to bottom.
92–126	Address Line #2	35	*e.g.*, Note the Agency Name field and the address lines will appear on the offset notice as follows: Agency Name—US Dept of Education
127–161	Address Line #3	35	Line #1—Federal Offset Program Line #2—J.J. Federal Building
162–196	Address Line #4	35	Line #3—124 Main St. Line #4—Anywhere, WA 11111
197–199	Filler	3	REQUIRED. Filler—Character Blank
200–225	Local Telephone Number	26	OPTIONAL. However, a local number is required if the toll-free number(s) is not available nationwide.
200	Telephone Type Indicator		REQUIRED. Enter a '1' if a telephone number is present. Enter a '0' if number not present.
201–214	*Telephone Number	14	REQUIRED. If TYPE is '0', blank fill. Otherwise, format '(202) 555-1212'
215	*Filler	1	REQUIRED. Blank fill
216–225	*Identifier	10	REQUIRED. Additional information for local number or blank fill. Examples: 'LOCAL' 'BALT ONLY' 'EXT 451' 'LOCAL BALT'
226–251	Instate Toll-Free Number	26	OPTIONAL
226	Telephone Type Indicator	1	REQUIRED. Enter a '2' if a telephone number is present. Enter a '0' if number not present.
227–240	*Telephone Number	14	REQUIRED. If TYPE is '0', blank fill. Otherwise, format '(800) 555-1212' or '1-202-555-1212'
241	*Filler	1	REQUIRED. Blank fill
242–251	*Identifier	10	REQUIRED. Example 'INSTATE XX' where XX is the state code for that number 'Toll Free' 'Collect'
252–277	Nationwide Toll-Free Number	26	REQUIRED
252	Telephone Type Indicator	1	REQUIRED. Enter a '3' to indicate a nationwide toll-free number or a '4' for collect.
253–266	*Telephone Number	14	REQUIRED. Format '(800) 555-1212' or '1-202-555-1212'
267	*Filler	1	REQUIRED. Blank fill
268–277	*Identifier	10	REQUIRED. Example 'NATIONWIDE' or 'TOLL-FREE' or 'Collect'
278–300	Filler	23	REQUIRED. Blank fill

* These 25 characters from each phone number segment will be displayed "as is" on IRS Offset Notices. See Exhibit A–4 in Part A, Sec. 10.05.

SEC. 16. TRANSMITTER-AGENCY ADDRESS DATA CONTROL RECORD

Identifies the cumulative count of agency address records on the Agency Address tape file. This record must appear as the last data record on the tape file.

RECORD NAME : AGENCY ADDRESS FILE CONTROL RECORD

Tape Position	Field Title	Length	Description and Remarks
1-4	CNTL	4	REQUIRED. Constant "CNTL"
5-10	Record Count	6	REQUIRED. Number of Addresses on Tape. Right justified, zero filled.
11-300	Filler	290	REQUIRED. Blank filled.

SEC. 17. TRANSMITTER-WEEKLY UPDATE RECORD

These records will be submitted on a weekly basis by the Transmitter. Each record must contain an SSN, agency code, subagency code, and name control for an obligor that was originally established on the DMF. The record will contain an indicator denoting either a decrease to the original obligation amount or that an offset(s) previously turned over to the participating agency has been refunded (fully or partially) directly to the obligor.

RECORD NAME : TRANSMITTER-WEEKLY UPDATE RECORD

Tape Position	Field Title	Length	Description and Remarks
1-2	Agency Code	2	REQUIRED. Code assigned to Agency by IRS
3-4	Subagency Code	2	REQUIRED. Code Assigned by Agency and recognized and approved by IRS. (See Definitions—Part A, Sec. 3)
5-8	Name Control	4	REQUIRED. Enter the first 4 significant characters of the obligor's last name. Last names of less than four characters should be left justified filling the unused positions with blanks. Embedded blanks should be removed. This field must be identical to the Name Control as submitted on the annual Certification Tape File for the obligor. (See Definitions—Part A, Sec. 3)
9-18	SSN	10	REQUIRED. Enter the obligor's Social Security Number as assigned by SSA. This field must be identical to the SSN as submitted on the Annual Certification Tape File for the obligor. Right justify and first numeric must be zero.
19	Type Indicator	1	REQUIRED. Enter the appropriate code from the table below TYPE INDICATOR — EXPLANATION: 0 — Decrease or deletion in amount of obligation. 1 — Refund or repayment by agency to obligor.
20-29	Amount of Adjustment	10	REQUIRED. Enter the amount of adjustment to the obligation amount. The amount must be significant and entered in dollars and cents. Do not enter positive or negative signs, signs, dollar signs, or decimal points. The amount of adjustment must be right justified and unused positions must be zero filled. If Type Indicator is '1', this field contains amount of agency refund repayment.
30-31	FILLER	2	REQUIRED. BLANK FILL
32-33	OFFSET YR	2	Significant on input for Refund/Repayment Records, record type(1) otherwise zero (0), for record type (0)
34-50	FILLER	17	REQUIRED. Blank Fill

SEC. 18. TRANSMITTER-WEEKLY UPDATE DATA CONTROL RECORD

Identifies the cumulative counts and amounts for all records on the Transmitter Weekly Update tape file. This record must appear as the last data record on the tape file which is submitted to IRS. If the counts and amounts do not balance when the tape is validated, the complete file is rejected and update functions are not performed.

RECORD NAME : TRANSMITTER-WEEKLY UPDATE CONTROL RECORD

Tape Position	Field Title	Length	Description and Remarks
1–4	Record ID	4	REQUIRED. Enter the constant "CNTL". This identifies the end of processable records.
5–10	Agency Refund/ Repayment Count	6	REQUIRED. Enter the cumulative record count of all records having a refund or repayment. (Type Indicator = 1)
11–16	Delete/Decrease County	6	REQUIRED. Enter the cumulative record count of all records having a decrease or deletion of the Amount Owed. (Type Indicator = 0)
17–28	Total Money Amounts	12	REQUIRED. Enter the cumulative total in Amount of Adjustment (TYPE 0 and TYPE 1 records). The amount must be entered in dollars and cents. Do not enter dollar signs, commas, decimal points or negative amounts. This field must be right justified and unused positions must be zero filled.
29–50	Filler	22	RESERVED. Fill with Blanks.

SEC. 19. SERVICE-WEEKLY UNPROCESSABLE UPDATE RECORD

Identifies Transmitter Weekly Update Records which are deemed unprocessable by IRS. The explanation for this can be found in the No Match Code field of the record. All fields (except No Match code field) will be the same as input on Transmitter Weekly Update record.

RECORD NAME : SERVICE-WEEKLY UNPROCESSABLE UPDATE RECORD

Tape Position	Field Title	Length	Description and Remarks
1–2	Agency Code	2	PRESENT. Code assigned to Agency by IRS.
3–4	Subagency Code	2	PRESENT. Code Assigned by Agency and recognized and approved by IRS. (See Definitions—Part A, Sec. 3)
5–8	Name Control	4	PRESENT. The first 4 significant characters of the obligor's last name. Last names of less than four characters will be left justified filling the unused positions with blanks. Special characters and embedded blanks will be removed. (See Definitions—Part A, Sec. 3)
9–18	SSN	10	PRESENT. The obligor's Social Security Number as assigned by SSA. Right justified and first numeric will be zero.
19	Type Indicator	1	PRESENT. The appropriate code from the table below. TYPE INDICATOR — EXPLANATION 0 — Decrease or deletion in amount of obligation. 1 — Refund or repayment by agency to obligor.
20–29	Amount of Adjustment	10	PRESENT. The amount of adjustment to the obligation amount. The amount will be entered in dollars and cents. Dollar signs, commas, decimal points or negative amounts will not be present. The amount of adjustment will be right justified and unused positions will be zero filled.
30–31	Unprocessable Code	2	PRESENT. IRS will insert the appropriate code from the table below. NO MATCH CODE — EXPLANATION: 01 — Invalid Agency Code 02 — Invalid SSN or Name Control 03 — Invalid Subagency Code 04 — No matching record on the DMF 05 — Delete previously processed for this obligor.

RECORD NAME : SERVICE-WEEKLY UNPROCESSABLE UPDATE RECORD—Continued

Tape Position	Field Title	Length	Description and Remarks	
			06	Agency Refund Repayment Record but no tax refund offset processed offset year.
			07	Invalid Type Indicator
			08	Delete caused obligation to fall below zero ($00.00). (Delete records will be processed by IRS, no-match code returned for information only.)
			09	Agency refund/repayment record amount in excess of offset (or original obligation if a delete or refund/ repayment was previously processed). Record not processed.
			10	Amount of adjustment is zero.
			11	For IRS use only.
			12	Duplicate record (same SSN, agency code, sub agency code & type).
			13-20	Reserved.
32-33	OFFSET YEAR	2	RESERVED. BLANK FILLED.	
34-50	FILLER	17	RESERVED. BLANK FILLED.	

SEC. 20. SERVICE-WEEKLY COLLECTION (OFFSET/CLAIM) RECORD

Identifies DMF accounts which had in the current week either a federal income tax refund offset or a spousal claim and will contain the amount of that action. If the action is an offset, the latest address information will be inserted at the end of the record. If the action is a claim the record will be blank filled.

RECORD NAME : SERVICE-WEEKLY COLLECTION (OFFSET/CLAIM) RECORD

Tape Position	Field Title	Length	Description and Remarks	
1	Type Indicator	1	PRESENT. A code will be inserted from the table below.	
			TYPE INDICATOR	EXPLANATION
			9	Claim by an injured spouse for a share of an offset due to not being liable for an obligation amount.
			1	Offset against the obligation amount.
2-3	Agency Code	2	PRESENT. Code assigned to Agency by IRS.	
4-5	Subagency Code	2	PRESENT. Code Assigned by Agency and recognized and approved by IRS. (See Definitions—Part A, Sec. 3)	
6-15	SSN	10	PRESENT. The obligor's Social Security Number as assigned by SSA. Right justified. The first numeric will be zero.	
16-25	Amount	10	PRESENT. The amount of offset or claim (depending upon Type Indicator). The amount will be dollars and cents. No dollars signs, commas, decimal points or negative amounts. The Amount is right justified and unused positions will be zero filled. If Type Indicator is '0', the amount will be for a claim. If Type Indicator is '1', the amount will be for an offset.	
26-27	Offset Year	2	PRESENT. Contains the last 2 digits of the year of the offset reversal. This field is applicable if the Type Indicator field contains a "0", otherwise, it will be filled with zeroes. It will be the processing year of the offset that a claim is being processed against.	

RECORD NAME : SERVICE-WEEKLY COLLECTION (OFFSET/CLAIM) RECORD—Continued

Tape Position	Field Title	Length	Description and Remarks
28-31	Tax Period	4	PRESENT. Will contain the tax period of the offset or claim. YYMM format.
32-51	Last Name	20	PRESENT. Contains the obligor's Last Name as submitted by agency. Left justified and filled with blanks.
52-66	First Name	15	PRESENT. Contains the obligor's First Name as submitted by agency. Left justified and filled with blanks.
67-81	Agency Case Number	15	PRESENT. Contains the obligor's case number as submitted by the agency. Use is recommended when an agency does not use the SSN as the primary account/case number. If not used, fill with blanks.
82	Filing Status*	1	PRESENT. Contains the appropriate code from the table below. FILING STATUS — EXPLANATION 0 — Other than Joint Return 2 — Joint Return
83-117	Name*	24	PRESENT. For Type 1 Offset records, contains the name of obligor as it appears on the IMF, and will be formatted—Last Name, First Name. *e.g.*, Public, John & Mary. Blank for Type 0 claim records.
118-152	Street Address*	35	PRESENT. For Type 1 Offset records, contains the current mailing address of the obligor. Left justified and blank filled. NOTE: the street address field may be blank. Blank for Type 0 claim records.
153-177	City and State*	25	PRESENT. For Type 1 Offset records, contains the obligor's city and state of residence. Left justified and blank filled. NOTE: the City/State field may contain City/Country for foreign addresses. Blank for Type 0 claim records.
178-182	ZIP Code*	5	PRESENT. For Type 1 Offset records, contains the obligor's ZIP Code. Blank for Type 0 claim records.
183-186	Name Control*	4	PRESENT. For Type 1 Offset records, contains the first 4 significant characters of the obligor's last name as found on IMF. Last names of less than four characters will be left justified filling the unused positions with blanks. Embedded blanks are removed (See Definitions—Part A, Sec. 3) Blank for Type 0 claim records.

*Note: These fields will be blank filled for Claim Type records.
(Type Indicator = 0)

Tape Position	Field Title	Length	Description and Remarks
187-190	OFFSET CYCLE	4	PRESENT. Format is YYCC.
191	FILLER	1	PRESENT. Blank Fill.
192-197	EFFECTIVE DATE OF OFFSET	6	PRESENT. FORMAT IS MMDDYY.
198-248	FILLER	51	REQUIRED. Blank Fill.
249-250.	AGENCY CODE	2	PRESENT.

SEC. 21. SERVICE-WEEKLY COLLECTION (OFFSET/CLAIM) DATA CONTROL RECORD

Identifies the cumulative counts and amounts for all records on the Service-Weekly Collection (Offset/Claim) tape file. This record will appear as the last data record for each subagency on the tape file that IRS will return to the submitting agency. Also present, as the last record on the file, will be a "CUM" control record containing counts and amounts of all records for the agency.

RECORD NAME : SERVICE-WEEKLY COLLECTION (OFFSET/CLAIM) CONTROL RECORD

Tape Position	Field Title	Length	Description and Remarks
1-4	Record ID	4	PRESENT. The constant "CNTL". This identifies the end of processable records for a subagency.

Tape Position	Field Title	Length	Description and Remarks
5–7	Block ID/ Subagency Code	3	PRESENT. The constant "CUM" or the appropriate subagency code. If "CUM" is used it will be the last record; otherwise, it will be a balancing record for all preceding records of same agency and subagency. Subagency code will be left justified.
8–15	Offset Record Count	8	PRESENT. The cumulative record count for all Offset records (Type Indicator = 1, on Service-Weekly Collection (Offset/ Claim) Record) current for that week. Right justified and zero filled.
16–27	Offset Amount	12	PRESENT. The cumulative total of all Offset Amounts (Type Indicator = 1, on Service-Weekly Collection (Offset/Claim) Record). The amount will be entered in dollars and cents. No dollar signs, commas, decimal points or negative amounts. The Offset Amount will be right justified and unused positions will be zero filled.
28–35	Claim Record Count	8	PRESENT. The cumulative record count for all Claim records (Type Indicator = 0, on Service-Weekly Collection (Offset/ Claim) Record) current for that week. Right justified and zero filled.
36–47	Claim Amount	12	PRESENT. The cumulative total of all Claim Amounts (Type Indicator = 0, on Service-Weekly Collection (Offset/Claim) Record). The amount will be entered in dollars and cents. No dollar signs, commas, decimal points or negative amounts. The Claim Amount will be right justified and unused positions will be zero filled.
48–59	Net Collections*	12	PRESENT. The absolute value of the Offset Amount minus the Claim Amount. The amount will be entered in dollars and cents. No dollar signs, commas, decimal points or negative amounts. This field will be right justified and unused positions will be zero filled.
60–71	Transfer Amount**	12	PRESENT. The amount of credits available. If the Offset Amount exceeds the Claim Amount, this field reflects Net Collections; otherwise filled with zeros.
72–83	Excess Claim** Amount	12	PRESENT. The amount of claims in excess of Offset. If the Claim Amount exceeds the Offset Amount, this field reflects Excess Claim amount; otherwise it is filled with zeroes.
84–186	FILLER	102	PRESENT. Filled with blanks.
187–190	Offset Cycle	4	PRESENT. Format is YYCC
191	FILLER	1	PRESENT. Blank filled.
192–197	Effective Date of Offset	6	PRESENT. Format is MMDDYY.
198–248	FILLER	53	PRESENT. Blank Filled.
249–250	AGENCY CODE	2	PRESENT.

*Note: If the Offset Amount exceeds the Claim Amount, the Transfer Amount will contain the same value. If the Claim Amount exceeds the Offset Amount, the Excess Claim Amount will contain this value.

**Note: When the Net Collections field is significant, only one of these fields will also be significant. In addition, the significant field will contain the same value as the Net Collections field.

SEC. 22. TRANSMITTER HEADER RECORDS

.01 The transmitter header records must be in ANSI standard label format.

.02 The File Identifier field (data set name-DSNAME) is in the HDR1 data set label. It is located in positions 5 thru 21 and must be left justified and blank filled. The File Identifier for the appropriate Agency files must be as follows:

RECORD TYPE	FILE NAME*@	FILE IDENTIFIER @
Pre-Offset Address Request	440-PO-##	I4403APO.AG##.IRS
Annual Certification	440-AC-##	I4403AAC.AG##.IRS
Agency Address	440-AA-##	I44020AA.AG##.IRS
Agency Address Update	480-AA-##	I48015AA.AG##.IRS
Weekly Update	445-WK-##	I44512WK.AG##.IRS

* See Part A, Sec. 4.03, for reference to File Name.

@—## is replaced with the appropriate Agency Code assigned by IRS.

e.g., Pre-Offset Address Request File Name = 440-PO-02
File Identifier = I4403APO.AG02.IRS

SEC. 23. SERVICE HEADER RECORDS

.01 The service header records will be in ANSI standard label format.

.02 The file identifier (data set name—DSNAME) in the HDR1 data set label for the appropriate files will be as follows:

Record Type	*File Name @*	*File Identifier @*
Pre-Offset Unprocessable Address Request	440-03-PO	044003PO.AG##.IRS
Pre-Offset Address Request	440-14-PO	044014PO.AG##.IRS
Annual Unprocessable Certification	440-03-AC	044003AC.AG##.IRS
Annual Nomatch Certification	440-08-AC	044008AC.AG##.IRS
Weekly Unprocessable Update	445-12-WK	044512WK.AG##.IRS
Weekly Collection	445-17-WK	04451WK.AG##.IRS

@—## is replaced with the appropriate Agency Code assigned by IRS.

e.g., Weekly Collection File Name = 445-17-WK
File Identifer = 04451WK.AG01.IRS

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 87-14, 1987-1 C.B. 599, is superseded.

---

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, Sections 263A, 446, 471, 472, 481, 1363; 1.263A-1T, 1.446-1, 1.471-2, 1.472-6, 1.481-1.)

Rev. Proc. 88-15

SECTION 1. PURPOSE

This revenue procedure allows certain taxpayers to obtain expeditious consent to discontinue the use of the last-in, first-out (LIFO) inventory method of accounting. Such discontinuation is a change in method of accounting within the meaning of sections 446 and 481 of the Internal Revenue Code. A taxpayer that complies with this revenue procedure has obtained the consent of the Commissioner to change its inventory method.

SEC. 2. BACKGROUND

.01 Section 446(e) of the Code states generally that a taxpayer that changes the method of accounting on the basis of which it regularly computes its income in keeping its books shall, before computing taxable income under the new method, secure the consent of the Secretary.

Section 1.446-1(e)(3)(i) of the Income Tax Regulations provides that, generally, in order to secure the Commissioner's consent to a change of a taxpayer's method of accounting, the taxpayer must file an application on Form 3115, Application for Change in Accounting Method, with the Commissioner of Internal Revenue, Washington, D.C., within 180 days after the beginning of the tax year for which the proposed change is to be made.

Section 1.446-1(e)(3)(ii) of the regulations states that the Commissioner may prescribe administrative procedures, subject to such limitations, terms, and conditions as deemed necessary to obtain consent, to permit taxpayers to change their accounting practices or methods to an acceptable treatment consistent with applicable regulations. Limitations, terms, and conditions, as may be prescribed in such administrative procedures by the Commissioner, shall include those necessary to prevent the omission or duplication of items includible in gross income or deductions.

.02 Section 481(a) of the Code requires that those adjustments necessary to prevent amounts from being duplicated or omitted be taken into account when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding tax year.

.03 Rev. Proc. 84-74, 1984-2 C.B. 736, contains procedures under section 1.446-1(e) of the regulations for obtaining the consent of the Commissioner to change a method of accounting for federal income tax purposes.

.04 Section 472(a) of the Code and section 1.472-3 of the regulations provide that a taxpayer may use the LIFO method in inventorying goods if the taxpayer files a statement with its income tax return for the tax year the method is first to be used. The statement shall be made on Form 970, Application to Use LIFO Inventory Method, in accordance with the form's instructions and the regulations under section 472.

.05 Section 472(e) of the Code and section 1.472-5 of the regulations provide that an election made to adopt and use the LIFO method is irrevocable. The method, once adopted, shall be used in all subsequent tax years, unless the use of another method is required by the

Commissioner, or authorized pursuant to a written application filed as provided in section 1.446-1(e).

.06 Section 1.472-6 of the regulations provides that if a taxpayer is granted permission to discontinue the use of the LIFO inventory method or if the taxpayer is required by the Commissioner to discontinue the use of such method because the taxpayer did not conform to the requirements of section 1.472-2, the inventory of the specified goods for the first tax year affected by the change and for subsequent tax years shall be taken:

(a) In conformity with the method used by the taxpayer under section 471 of the Code for goods not included in its LIFO inventory computations; or

(b) If the LIFO inventory method was used by the taxpayer with respect to all of the taxpayer's goods, then in conformity with the inventory method used by the taxpayer prior to the taxpayer's adoption of the LIFO inventory method; or

(c) If the taxpayer did not use inventories prior to adoption of the LIFO inventory method and has no goods currently subject to inventory by a method other than the LIFO inventory method, then in conformity with such inventory method as may be selected by the taxpayer and approved by the Commissioner as resulting in a clear reflection of income; or

(d) In any event, in conformity with any inventory method to which the taxpayer may change pursuant to an application approved by the Commissioner.

.07 Section 472(c) of the Code requires a taxpayer using the LIFO inventory method to use no other procedure, in inventorying its goods to ascertain the income, profit, or loss of the first tax year for which the LIFO inventory method is to be used, for purposes of a report or statement covering such tax year to shareholders, partners or other proprietors, or beneficiaries, or for credit purposes. Section 472(e) extends this conformity requirement to subsequent tax years.

.08 Section 472(g)(1) of the Code provides that all memebers of the same group of financially related corporations shall generally be treated as one taxpayer for purposes of sections 472(c) and 472(e).

.09 Rev. Proc. 79-23, 1979-1 C.B. 564, lists certain situations that warrant the disallowance or termination of a LIFO election.

.10 Section 6.02 of Rev. Proc. 84-74 defines Category A methods of accounting as methods of accounting that are specifically not permitted to be used by the taxpayer by the Code, regulations, or a decision of the Supreme Court of the United States or certain methods that are clearly erroneous. Section 6.02(4)(10) of Rev. Proc. 84-74 states that an example of a Category A method is the use of the LIFO method of accounting for inventories when there has been a termination event (as described in Rev. Proc. 79-23 or any other applicable revenue ruling or revenue procedure) that occurred during a year not barred by the statute of limitations as of the date of the filing of the Form 3115.

.11 Section 1363(d) of the Code (as added by the Revenue Act of 1987) requires that if a C corporation uses the LIFO inventory method for its last tax year before an S election becomes effective, the LIFO recapture amount, as defined in section 1363(d)(3), shall be included in the gross income of the C corporation for such last tax year and that any increase in tax for the last taxable year as a C corporation shall be payable in 4 equal installments.

.12 Section 263A of the Code provides a uniform set of rules to be applied in determining the costs required to be included in inventory costs for tax years beginning after December 31, 1986. For the first tax year beginning after December 31, 1986, taxpayers that are required by section 263A to change their method of accounting may automatically change that method in accordance with the provisions of section 1.263A-1T(e)(11) of the temporary regulations. Taxpayers that are required to change their method of accounting and that fail to comply with the requirements of section 1.263A-1T(e)(11) are using an improper method of accounting.

SEC. 3. SCOPE

.01 Except as provided in section 3.02 below, this revenue procedure applies to any taxpayer that desires to (1) discontinue the use of the last-in, first-out (LIFO) inventory method for all of its LIFO inventory and (2) change to the permitted method determined in section 4.02(1) of this revenue procedure.

Taxpayers to which this revenue procedure applies may not use Rev. Proc. 84-74 for changes with respect to which this revenue procedure applies.

.02 This revenue procedure does not apply to:

(1) Any taxpayer that, as of the date of the filing of the Form 3115 with the National Office, has been contacted in any manner by a representative of the Service for the purpose of scheduling an examination of its federal income tax return(s) for any year, if the examination has not been completed, unless the taxpayer has obtained and attaches to its Form 3115 an agreement from the Service's examining agent that there is no objection to the proposed change in method of accounting;

(2) Any taxpayer that, as of the date of the filing of the Form 3115 with the National Office, is:

(a) Before an appeals office of the Service with respect to an examination of its federal income tax return(s) for any year, unless the taxpayer has obtained and attaches to its Form 3115 an agreement from the appeals officer that there is no objection to the proposed change in method of accounting, or

(b) Before any federal court with respect to an income tax issue arising in any year, unless the taxpayer has obtained and attaches to its Form 3115 an agreement from counsel for the Government that there is no objection to the proposed change in method of accounting;

(3) Any taxpayer that, as of the date of the filing of the Form 3115 with the National Office, is the subject of a criminal investigation or proceeding concerning (a) directly or indirectly the taxpayer's federal tax liability for any year, or (b) the possibility of false or fraudulent statements made by the taxpayer with respect to any issue relating to its federal tax liability for any year;

(4)(a) If the tax year preceding the year of change begins (or, pursuant to section 1.441-2(b)(1) of the regulations, is deemed to begin) after December 31, 1986, any taxpayer that, for that preceding tax year, uses an impermissible method of determining costs incurred in the production or acquisition of inventory property (in particular, any taxpayer whose method violates the provisions of section 263A of the Code and the regulations thereunder); or

(b) If the tax year preceding the year of change begins (or is deemed to begin) before January 1, 1987, any taxpayer that, for that preceding tax year, uses an impermissible method of determining costs incurred in the production or acquisition of inventory property, unless that taxpayer, for the year of change, changes that method according to the procedures prescribed in section 1.263A-1T(e)(11) of the temporary regulations (concerning a change to comply with section 263A of the Code);

(5) Any taxpayer for which, as of the date of the filing of the Form 3115 with the National Office, a termination event other than the one described in section 3.02(6) of this revenue procedure has occurred during a year not barred by the statute of limitations (For purposes of this revenue procedure, a "termination event" is a situation [as described in Rev. Proc. 79-23 or any other applicable revenue ruling or revenue procedure] that warrants the termination of a LIFO election; provided, however, that the term "termination event" does not include the issuance of nonconforming financial statements if the first such issuance occurs in the tax year in which the request to discontinue the LIFO inventory method is properly filed.);

(6) Any taxpayer that uses the LIFO inventory method and issues nonconforming financial statements in violation of section 472(g) of the Code for any tax year beginning on or after July 18, 1984, unless the first such issuance occurs in the tax year in which the request to discontinue the LIFO inventory method is properly filed;

(7) Any taxpayer that did not file Form(s) 970 to elect the LIFO inventory method and, if applicable, to extend the use of the LIFO method to other items of inventory (For a taxpayer that properly elected the LIFO inventory method but is unable to furnish a copy of the Form(s) 970, see section 7.06 of this revenue procedure.);

(8) A cooperative within the meaning of section 1381(a) of the Code that seeks to justify a section 481(a) adjustment period of more than 1 tax year; or

(9) Any taxpayer that filed a Form 3115 with the National Office under this revenue procedure or under Rev. Proc. 84-74 requesting permission to discontinue the use of the LIFO inventory method for an earlier tax year and that did not effect the requested change.

.03 Any taxpayer to which this revenue procedure does not apply and which desires to discontinue its use of the LIFO inventory method must file a current Form 3115 with the Commissioner in accordance with the requirements of section 1.446-1(e)(3) of the regulations and Rev. Proc. 84-74. If the year of change is the first tax year that the taxpayer is subject to section 263A of the Code and, in order to comply with the provisions of section 263A of the Code and the regulations thereunder, the taxpayer is also changing its method of accounting for determining costs incurred in the production or acquisition of inventory property, see Notice 88-23, page 490, this Bulletin.

SEC. 4. APPLICATION

.01 *Consent.* In accordance with section 1.446-1(e)(3)(ii) of the regulations, the requirement to file an application on Form 3115 within a 180-day period is waived, and under section 1.446-1(e)(2)(i) consent is hereby granted to any taxpayer within the scope of this revenue procedure to discontinue the use of the LIFO inventory method. This consent is granted for the tax year (year of change) for which a taxpayer requests a change by filing a current Form 3115 in the manner described in section 7 of this revenue procedure. See section 6 regarding compliance with the conditions of this revenue procedure.

.02 *Method to be Used.*

(1) The inventory method to be used by a taxpayer is determined as follows:

(a) If the taxpayer has inventoriable goods not included in its LIFO inventory computations (non-LIFO inventory) and, for all of the taxpayer's non-LIFO inventory, the taxpayer uses an inventory method that is a permitted method, as defined in section 4.02(2) of this revenue procedure, then the taxpayer must use that same inventory method for its entire inventory.

(b) If the LIFO inventory method is used by the taxpayer with respect to all of the taxpayer's inventoriable goods, then the taxpayer must use the same inventory method it used prior to the adoption of the LIFO inventory method if that prior method is a permitted method, as defined in section 4.02(2).

(c) If the taxpayer has only LIFO inventory and the method used by the taxpayer prior to the adoption of the LIFO inventory method is not a permitted method, as defined in section 4.02(2), then the taxpayer must use a method that is a permitted method, as defined in section 4.02(2).

(d) If the taxpayer had not used inventories prior to the adoption of the LIFO inventory method and has no inventoriable goods other than its LIFO inventory, then the taxpayer must use a permitted method, as defined in section 4.02(2).

(2) For purposes of this revenue procedure, a permitted method is a method under which:

(a) The identification method is either the first-in, first-out (FIFO) method or the specific identification method, and

(b) The valuation method is cost; cost or market, whichever is lower; market (but only if the taxpayer is a dealer in securities, as defined in section 1.471-5 of the regulations); the "farm-price method" or the "unit-livestock-price method" (but only if the taxpayer is a farmer permitted to use such methods); or the retail method, reduced to either approximate cost or approximate cost or market, whichever is lower (but only if the taxpayer is a retail merchant).

It should be noted that the average cost method (sometimes also referred to as "the rolling average method") described in Rev. Rul. 71-234, 1971-1 C.B. 148, is not a permitted method.

Whether an inventory method is a permitted method is determined by the taxpayer's method of inventory identification and valuation and not by which types and amounts of costs are capitalized under the taxpayer's method of computing inventory cost. See section 263A of the Code and the regulations thereunder, which govern the types and amounts of costs required to be included in inventory cost for taxpayers subject to its provisions.

.03 *Section 481(a) Adjustment.* The section 481(a) adjustment shall be taken into account in the manner set forth in section 5 of this revenue procedure.

.04 *Conformity.* For the year of change and for later tax years, the taxpayer must keep its tax books and records on the inventory identification and valuation method determined under section 4.02(1) of this revenue procedure. Further, it must use this method for all reports to shareholders, partners or other proprietors, or beneficiaries, including financial statements and statements for credit purposes. Notwithstanding the preceding sentence, costs that are required to be capitalized under section 1.263A-1T(b) of the temporary regulations need not be capitalized in determining the cost of inventoriable goods in reports to shareholders, partners or other proprietors, or beneficiaries.

.05 *Limitation on LIFO Election.* The taxpayer may not elect the LIFO inventory method for a period of at least 10 tax years beginning with the year of change, unless, based on a showing of extraordinary circumstances, permission is requested, and consent is specifically granted by the Commissioner, to change the method of accounting at an earlier time. The request should comply with Rev. Proc. 84-74 and should be addressed to: Internal Revenue Service, Corporation Tax 4, Attn: CC:IND:D:C, P.O. Box 7604, Benjamin Franklin Station, Washington, D.C. 20044.

SEC. 5. SECTION 481(a) ADJUSTMENT

.01 An adjustment, referred to as the section 481(a) adjustment, is required to prevent items from being duplicated or omitted when a change in method of accounting is made. The section 481(a) adjustment is the difference between (a) the value of the taxpayer's LIFO inventory as of the beginning of the year of change under the taxpayer's LIFO method (adjusted for any LIFO recapture amount previously included in gross income under section 1363 of the Code, if applicable) and (b) the value of that inventory under the method determined under section 4.02 of this revenue procedure. If the year of change is the taxpayer's first tax year that the taxpayer is subject to section 263A of the Code, the cost of the taxpayer's inventory under (b) shall generally be determined using the taxpayer's method for computing cost for the prior tax year. See Notice 88-23. (The difference between the cost of inventory under such prior tax year's method and the cost of inventory under the provisions of section 263A and the regulations thereunder is to be taken into account in accordance with the provisions of section 1.263A-1T of the temporary regulations.) If (b) is greater than (a), then the section 481(a) adjustment is referred to as a positive adjustment. If (a) is greater than (b), then the section 481(a) adjustment is referred to as a negative adjustment. The section 481(a) adjustment shall be taken into account in computing taxable income in the manner provided in section 5.02 below. For purposes of determining the amount of the section 481(a) adjustment, the approved change shall be considered a change in method of accounting initiated by the taxpayer; therefore, the section 481(a) adjustment is not to be reduced in any way by a pre-1954 amount.

.02 *Section 481(a) Adjustment Period.*

(1) The appropriate period (adjustment period) for taking into account the adjustment, whether positive or negative, referred to in section 5.01, is determined as follows:

(a) If the entire amount of the adjustment is attributable to the tax year immediately preceding the year of change (first preceding year), the total adjustment is to be taken into account in computing taxable income for the year of change. The amount attributable to the tax year immediately preceding the year of change is the amount of the adjustment determined under section 481(a) of the Code for the year of change less the amount of the adjustment that would have been required under section 481(a) if the same change in method of accounting had been made for such preceding year.

(b) If subparagraph (a) of this section 5.02(1) does not apply, the LIFO inventory method has been used for more than 4 tax years, and 67 percent or more of the adjustment is attributable to the 1-tax-year period, 2-tax-year period, or 3-tax-year period immediately preceding the year of change, the highest percent attributable to such 1-, 2-, or 3-tax-year period is to be taken into account ratably over a 3-tax-year period beginning with the year of change. Any remaining balance is to be taken into account ratably over an additional period equal to the remainder of the number of tax years the taxpayer has used the LIFO inventory method. However, the total adjustment period shall not exceed 6 tax years. The amount attributable to the 1-, 2-, or 3-tax-year period immediately preceding the year of change is the amount of the adjustment determined under section 481(a) of the Code for the year of change less the amount that would have been required under section 481(a) if the same change had been made at the beginning of such preceding 1-, 2-, or 3-tax-year period. If the LIFO inventory method has been used for 4 tax years, 75 percent shall be substituted for 67 percent.

(c) A cooperative within the meaning of section 1381(a) of the Code shall take the total amount of the adjustment into account in computing taxable income for the year of change. See Rev. Rul. 79-45, 1979-1 C.B. 284.

(d) In all other situations in which subparagraphs (a), (b), and (c) of this section 5.02(1) do not apply, the adjustment is to be taken into account ratably over the lesser of (i) the number of tax years the taxpayer has used the LIFO inventory method or (ii) 6 tax years.

(2) In applying section 5.02(1), if a taxpayer's books and records do not contain sufficient information to compute the section 481(a) adjustment that would have been required if the same change had been made at the beginning of such preceding 1-, 2-, or 3-tax-year period, the taxpayer may reasonably estimate these amounts, attach the computations upon which the estimates are based, and also sign and attach the following statement to the Form 3115:

Under penalties of perjury, I hereby certify that:

> (a) The books and records of [name of the taxpayer] do not contain sufficient information to permit a computation of the section 481(a) adjustment attributable to the 1-tax-year period, 2-tax-year period, or 3-tax-year period immediately preceding the year of change as required by section 5.02(1) of Rev. Proc. 88-15.
>
> (b) Based on the information that is contained in such records, to the best of my knowledge and belief, the entire amount of the section 481(a) adjustment for the year of change [indicate either "is" or "is not," as the case may be] attributable to the tax year immediately preceding the year of change, and 67 percent [or "75 percent," in applicable cases] or more of the section 481(a) adjustment for the year of change [indicate "is" or "is not," as the case may be] attributable to the 1-tax-year period, 2-tax-year period, or 3-tax-year period immediately preceding the year of change.

(3) For examples of the application of the rules prescribed in section 5.02(1) with respect to the appropriate period for taking into account the section 481(a) adjustment, see section 5.14 of Rev. Proc. 84-74.

.03 *Inventory Reduction.*

(1) If, on the last day of any tax year of the adjustment period, the value of the taxpayer's inventory to which the section 481(a) adjustment relates is reduced by more than 33-1/3 percent of the inventory value at the beginning of the first tax year of the adjustment period and is so reduced by at least such percentage at the end of the following tax year, the remaining balance of the section 481(a) adjustment must be taken into account in determining taxable income in the year succeeding the year of reduction. Permanent reductions, not temporary fluctuations, are controlling. If the value of the inventory does not remain reduced for one tax year, the reduction is not considered permanent, and the provisions of this paragraph do not apply. (For an example of the calculation, see section 5.08 of Rev. Proc. 84-74.)

(2) Section 5.03(1) shall not apply if the taxpayer shows to the satisfaction of the Commissioner that the reduction in inventory is attributable to a strike, involuntary conversion, or involuntary interruption of the availabilty of goods. Section 5.03(2) shall apply only if the taxpayer obtains the consent of the Commissioner to continue to spread the section 481(a) adjustment. The consent must be requested no later than 90 days after the end of the tax year in which section 5.03(1) would otherwise apply. The request should comply with section 5.08(2) of Rev. Proc. 84-74 and should be addressed to: Internal Revenue Service, Corporation Tax 4, Attn: CC:IND:D:C, P.O. Box 7604, Benjamin Franklin Station, Washington, D.C. 20044.

.04 *Ceasing to Engage in the Trade or Business.*

(1) With respect to a corporation:

If the corporation ceases to engage in the trade or business to which the adjustment described in section 5.01 relates at any time prior to the expiration of the adjustment period referred to in section 5.02, the taxpayer shall take into account in that year the balance of the adjustment not previously taken into account in computing taxable income. See Rev. Rul. 80-39, 1980-1 C.B. 112, which holds that in the case of a corporation with a different division for each trade or business, if the corporation ceases to engage in the trade or business of a division that has been granted a change in method of accounting, the remaining portion of the section 481(a) adjustment applicable to that trade or business must be taken into account in computing income in the year the corporation ceases to engage in that trade or business. For purposes of section 5.04, the taxpayer is not considered to have ceased to engage in a trade or business if its assets have been acquired by another corporation in a transaction to which section 381 of the Code applies, but in that case the acquiring corporation shall continue to be subject to this revenue procedure as though it were the acquired corporation.

(2) With respect to a partnership:

In the event a partnership terminates (within the meaning of section 708(b) of the Code) or ceases to engage in the trade or business to which the adjustment described in section 5.01 relates at any time prior to the expiration of the adjustment period referred to in section 5.02, the balance of the adjustment not previously taken into account in computing ordinary income shall be taken into account in that year. A partnership is treated as ceasing to engage in a trade or business upon the incorporation of the trade or business in a transaction to which section 351 of the Code applies (see Rev. Rul. 85-134, 1985-2 C.B. 160).

(3) With respect to a sole proprietor:

If an individual (sole proprietor) ceases to engage in the trade or business to which the adjustment described in section 5.01 relates at any time prior to the expiration of the adjustment period referred to in section 5.02, the balance of the adjustment not previously taken into account in computing taxable income shall be taken into account in that year. A sole proprietor is treated as ceasing to engage in a trade or business upon the incorporation of the trade or business in a transaction to which section 351 of the Code applies (see Rev. Rul. 77-264, 1977-2 C.B. 187). A sole proprietorship is not treated as ceasing to engage in a trade or business upon the sale of a partial interest in the proprietorship if the individual who was the sole proprietor continues to be actively engaged in the management of the business and it is subsequently operated as a partnership. The section 481(a) adjustment remaining at the time the partnership is formed is taken into account by the sole proprietor in computing the sole proprietor's own taxable income as though there had been no change in ownership (see Rev. Rul. 66-206, 1966-2 C.B. 206).

.05 *Effect of Subchapter S Election by Corporation.*

(1) If the taxpayer is described in section 5.05(1)(a) of this revenue procedure, the balance of the section 481(a) adjustment (not previously taken into account) must be taken into account in its last year as a C corporation. Any increase in the tax for the last year as a C corporation shall be payable as provided in section 5.05(1)(b).

(a) A taxpayer is described in this section 5.05(1)(a) if:

(i) The taxpayer is a C corporation for the year of change;

(ii) The section 481(a) adjustment is positive;

(iii) After December 17, 1987, the taxpayer makes an S election that is effective for one or more tax years in which, but for this section 5.05, some portion of the section 481(a) adjustment would have been taken into account; and

(iv) In the case of an election made before January 1, 1989, then, on or before December 17, 1987, there was neither (A) a resolution adopted by the board of directors of the taxpayer to make the S election nor (B) a ruling request with respect to the business filed with the Service expressing an intent to make such an election.

(b) If a taxpayer is described in section 5.05(1)(a) of this revenue procedure and if the inclusion of the balance of the section 481(a) adjustment results in any increase in tax for its last taxable year as a C corporation over the tax for its last taxable year as a C corporation over the tax that would have been due for that tax year if no portion of the section 481(a) adjustment had been so included, then that increase shall be payable as follows:

(i) Except as provided in (b)(iii), below, the increase shall be payable in equal installments, and the number of installments shall be the lesser of (A) 4, or (B) the number of tax years remaining in the portion of the adjustment period under section 5.02 starting with the taxpayer's last year as a C corporation.

(ii) The first installment shall be paid on or before the due date (determined without regard to extensions) for the income tax return for the taxpayer's last year as a C corporation, and, except as provided in (b)(iii) below, one installment (if any remain) shall be paid on or before the due date (determined without regard to extensions) for such corporation's income tax return for each succeeding tax year until all the installments are paid.

(iii) If, in the absence of this section 5.05, section 5.03 or 5.04 of this revenue procedure would have required the taxpayer to take into account in a single tax year the balance of the section 481(a) adjustment not previously taken into account, then any or all installment(s) that otherwise would have been due after the due date (determined without regard to extensions) for the taxpayer's income tax return for that tax year shall, instead, be paid on or before the due date (determined without regard to extensions) of such return.

(iv) For purposes of section 6601 of the Code (relating to assessment of interest on underpayment of tax), the date(s) prescribed for the payment of any installment(s) that are described in this section 5.05 shall be determined under section 5.05(1)(b)(ii) and (iii) of this revenue procedure.

(c) For example, assume that *PJ* corporation, a taxpayer that files returns on a calendar year basis, requests pursuant to section 4 of this revenue procedure to discontinue the use of LIFO inventory method for its tax year beginning January 1, 1989. Also assume that the section 481(a) adjustment, calculated under section 5 of this revenue procedure, is $600 and will be taken into income by the corporation in 6 equal installments of $100 for the 1989-1994 tax years. If *PJ* corporation files an S election to be effective beginning January 1, 1990, then, pursuant to section 5.05(1) of this revenue procedure, *PJ* corporation must include the balance of the section 481(a) adjustment ($600) in income for its 1989 tax year. Any increase in tax imposed by reason of such inclusion is payable in four equal installments on or before the due dates (determined without regard to extensions) for the income tax returns of *PJ* corporation for its 1989-1992 tax years. If *PJ* corporation, instead, files an S election to be effective beginning January 1, 1993, it will have included $300 of the section 481(a) adjustment in income for its 1989-1991 tax years. Pursuant to section 5.05(1) of this revenue procedure, *PJ* corporation includes the remainder of the section 481(a) adjustment ($300) in income for its 1992 year. Any increase in tax imposed by reason of such inclusion is payable in three equal installments on or before the due dates (determined without regard to extensions) for the income tax returns of *PJ* corporation for its 1992-1994 tax years.

(2) If the taxpayer makes an S election that is first effective for the year of change, then, as provided in section 1363 of the Code, the taxpayer shall take the LIFO recapture amount (as defined in section 1363) into gross income for the taxpayer's last tax year as a C corporation (which is the year preceding the year of change). Any increase in income tax as a result of that inclusion shall be payable as provided in section 1363, that is, in 4 equal installments, beginning with the taxpayer's last tax year as a C corporation. As provided in section

1363, the taxpayer shall adjust the basis of its inventory as of the end of that last year as a C corporation to take into account the inclusion in income of the LIFO recapture amount. After having made this adjustment to basis, the taxpayer shall then calculate the section 481(a) adjustment, if any, according to the provisions of section 5.01 of this revenue procedure. If there is a section 481(a) adjustment (either positive or negative), the adjustment shall be taken into account as provided elsewhere in this section 5 (generally, over a period not to exceed 6 tax years, beginning with the year of change, which is the first tax year for which the S election is effective).

.06 *Net Operating Loss Carryover and Net Operating Losses.*

(1) No part of any (consolidated or separate) net operating loss carryover available at the beginning of the year of change may be used as an offset against the portion of the positive section 481(a) adjustment taken into account in the year of change. That is, the net operating loss carryover available at the beginning of the year of change may be offset only against income (other than the section 481(a) adjustment) generated in the year of change. This condition does not apply to years subsequent to the year of change. Any portion of the positive section 481(a) adjustment attributable to the year of change may be offset against any net operating loss otherwise incurred in the year of change as well as against any future net operating loss carryback under section 172(b) of the Code.

(2) Any portion of any net operating loss arising in the year of change or in any subsequent year in the adjustment period that is attributable to the negative section 481(a) adjustment may not be carried to those 3 tax years preceding the year of change to which section 172 of the Code otherwise would require it first to be carried.

.07 *Credit Carryover.* No part of any (consolidated or separate) credit carryover available at the beginning of the year of change may be used to reduce the federal income tax liability resulting from, or attributable to, the inclusion in income of a portion of the positive section 481(a) adjustment in the year of change. This restriction does not apply to a credit arising in the year of change or to any future credit carrybacks to the year of change.

SEC. 6. COMPLIANCE WITH CONDITIONS

If a taxpayer to which this revenue procedure applies discontinues the use of the LIFO inventory method without complying with all the conditions of this revenue procedure, then that taxpayer has made the change in inventory method without obtaining the permission of the Commissioner as required under section 446(e) of the Code.

SEC. 7. MANNER OF EFFECTING THE CHANGE

.01 The taxpayer applying for a change in method of accounting pursuant to this revenue procedure must complete and file a current Form 3115 in duplicate. A copy of the Form 3115 shall be filed with the National Office addressed to Internal Revenue Service, Corporation Tax 4, P.O. Box 7616, Benjamin Franklin Station, Washington, D.C. 20044. No user fee is required for an application filed under this revenue procedure.

The copy of the Form 3115 that is filed with the National Office must be filed within 270 days after the beginning of the year of change. The original of the Form 3115 shall be attached to the taxpayer's timely filed (determined with regard to extensions) federal income tax return for the year of change.

If the taxpayer is also changing its method of accounting for determining costs incurred in the production or acquisition of inventory property to comply with the provisions of section 263A of the Code and the regulations thereunder and if the year of change is the first tax year that begins (or is deemed to begin) in 1987 and that the taxpayer is subject to section 263A of the Code, then the following two requirements apply in lieu of those stated in the preceding paragraph. First, the copy of the Form 3115 must be filed with the National Office (1) within 270 days after the beginning of the year of change or (2) if later, on or before May 6, 1988, which is 60 days after the publication of this revenue procedure in the Internal Revenue Bulletin. Second, the original of the Form 3115 shall be attached to the taxpayer's original or amended federal income tax return for the year of change, provided that such return is filed no later than the 15th day of the 10th month following the close of the year of change.

.02 In order to assist in the processing of these changes in method of accounting and to insure proper handling, reference to this revenue procedure shall be made a part of the Form 3115 by either typing or legibly printing the applicable statement at the top of page 1 of Form 3115:

(1) For taxpayers complying with the provisions of sections 263A of the Code for the first tax year that begins (or is deemed to begin) in 1987 and that the taxpayer is subject to section 263A: "FILED UNDER NOTICE 88-23 AND REV. PROC. 88-15."

(2) For all other taxpayers: "FILED UNDER REV. PROC. 88-15."

.03 In addition to including all of the information required on the Form 3115, the taxpayer must (1) state that it agrees to all of the conditions of Rev. Proc. 88-15 and that it proposes to take the section 481(a) adjustment into account over the appropriate period required by section 5.02, and (2) identify the period over which the section 481(a) adjustment will be taken into account and the basis for concluding that the identified period is correct. If the Service finds that the taxpayer does not qualify for the change in method of accounting under this revenue procedure, the National Office or the district director will so advise the taxpayer.

.04 *Termination Event Statement.* The taxpayer must sign the following statement and attach it to the Form 3115:

> Under penalties of perjury, I hereby certify that to the best of my knowledge and belief, with respect to [*name of taxpayer*]'s use of the LIFO inventory method, no termination event (as defined in section 3.02(5) of Rev. Proc. 88-15) has occurred during a year not barred by the statute of limitations as of the date of the filing of the Form 3115 with the National Office.

.05 *Statement of Proposed Method.* The taxpayer must complete the following statements and attach them to the Form 3115:

(1) The proposed method of identifying inventory goods will be the [insert method; i.e., specific identification; first-in, first-out; retail; etc.] method.

(2) The proposed method of valuing inventory goods will be [insert method; i.e., cost; cost or market, whichever is lower; etc.].

(3) This method conforms to the requirements of section 4.02(1) [insert either (a), (b), (c), or (d)] of Rev. Proc. 88-15 in that [explain in detail how the proposed method conforms to the specific subsection].

.06 The taxpayer must attach to the Form 3115 either (1) a copy of the Form(s) 970 filed to adopt the LIFO inventory method and, if applicable, to extend the use of the method, or (2) if the taxpayer properly elected the LIFO inventory method but is unable to furnish a copy of such Form(s) 970, the following statement, signed by the taxpayer:

> Under penalties or perjury, I certify that to the best of my knowledge and belief, [*name of taxpayer*] properly elected the LIFO inventory method by filing a Form 970 with its return for the taxable year(s) ended [*insert date(s)*] and otherwise complied with the provisions of section 472(d) of the Code and 1.472-3 of the regulations.

.07 The signature of the person preparing the request for change in method of accounting must appear in the space provided for it on the Form 3115. The Form 3115 must be signed by or on behalf of the taxpayer requesting the change. For example, an officer must sign on behalf of a corporation, a general partner on behalf of a partnership, a trustee on behalf of a trust, or the individual taxpayer on behalf of a sole proprietorship. See the signature requirements set forth in the General Instructions attached to a current Form 3115 regarding those who are to sign. If an agent is authorized to represent the taxpayer before the Service, to receive the original or a copy of the coorespondence concerning the request, or to perform any other act(s) regarding the application on behalf of the taxpayer, a power of attorney reflecting such authorization(s) must be attached to the application. A taxpayer's representative without a power of attorney to represent the taxpayer as indicated in this subsection will not be given any information regarding the application.

.08 If the taxpayer is a member of an affiliated group that has elected to file a consolidated federal income tax return, the Form 3115 submitted on behalf of the taxpayer must be signed by a duly authorized officer of the common parent. (See section 1.1502-77 of the regulations.)

.09 For early applications, except as stated below, see section 5.03 of Rev. Proc. 84-74. The statement (described in section 7.02 of this revenue procedure) to be typed or legibly printed at the top of page 1 of the Form 3115 should read: "EARLY APPLICATION FILED UNDER REV. PROC. 88-15." Within the first 270 days after the beginning of the year of change, the taxpayer must file with the National Office a copy of a complete and perfected Form 3115. The original of the complete and perfected Form 3115 is to be attached to the taxpayer's timely filed (determined with regard to extensions) federal income tax return for the year of change. Unlike the early application procedure under Rev. Proc. 84-74, the taxpayer will not be notified during the 270-day period if the early application has not been perfected.

SEC. 8. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, Attention: CC:C:4, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

SEC. 9. EFFECTIVE DATE

This revenue procedure is effective March 7, 1988, the date of its publication. Any request for change in method of accounting filed under the provisions of Rev. Proc. 84-74 that qualifies under this revenue procedure and is received in the National Office after the effective date will be returned to the taxpayer. Any taxpayer that has timely filed a Form 3115 under Rev. Proc. 84-74 with the National Office prior to the effective date of this revenue procedure and that has not filed its federal income tax return for the requested year of change may use the automatic provisions of this revenue procedure, if such taxpayer otherwise qualifies under this revenue procedure, and will be notified to this effect by the National Office.

SEC. 10. EFFECT ON OTHER DOCUMENTS

.01 As described below, sections 5.10(1)(b) and 6.02(4)(10) of Rev. Proc. 84-74 are modified to conform to sections 3.02(5) and 3.02(6) of this revenue procedure.

The following language is inserted above the final paragraph of section 5.10(1)(b) and as a new paragraph at the end of section 6.02(4)(10) of Rev. Proc. 84-74:

> For purposes of this revenue procedure, a termination event does not include the issuance of nonconforming financial statements if the first such issuance occurs in the tax year in which the request to discontinue the LIFO inventory method is properly filed.

.02 The following language is inserted as new subparagraphs (c) and (d) of section 5.10(1) of Rev. Proc. 84-74:

> (c) *Condition relating to a subsequent S election.* If the Commissioner approves a taxpayer's request to discontinue the use of the LIFO inventory method of accounting, the Commissioner will impose a condition consistent with the provisions of section 5.05(1)(b) of Rev. Proc. 88-15, applicable to taxpayers described in section 5.05(1)(a) of that revenue procedure (certain taxpayers making a subsequent S election).
>
> (d) *Taxpayer making an S election.* If, after the effective date of section 1363(d) of the Code, the taxpayer makes an S election that is first effective for the year of change, then section 1363(d) requires both (i) an increase in the taxpayer's gross income for the tax year preceeding the year of change and (ii) a corresponding adjustment to the basis of the taxpayer's inventory as of the end of such preceeding tax year. This basis adjustment is taken into account in the computation of the section 481(a) adjustment that results from discontinu-

ing the use of the LIFO inventory method. See section 5.05(2) of Rev. Proc. 88-15.

---

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, Section 6231; 301.6231(a)(7)-1T.)

Rev. Proc. 88-16

SECTION 1. PURPOSE

This revenue procedure describes circumstances under which the Internal Revenue Service will select a tax matters partner (TMP) for a partnership pursuant to section 6231(a)(7) of the Internal Revenue Code. It also describes criteria the Service will consider in selecting the TMP.

SEC. 2. BACKGROUND

.01 Title IV of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), 1982-2 C.B. 462, 585, changed the examination and administrative procedures for partnership items, which are defined in section 301.6231(a)(3)-1 of the Regulations on Procedure and Administration. The rules are applicable to partnership taxable years beginning after September 3, 1982, and are also applicable to any partnership taxable year beginning on or before, and ending after, September 3, 1982, if the partnership, each partner, and each indirect partner requests such application and the Secretary consents.

.02 Prior to TEFRA, tax adjustments were made at the partner level. Under provisions added by TEFRA, the tax treatment of partnership items is generally determined at the partnership level through a unified administrative and judicial proceeding, even though the tax liability that results from such a determination is imposed on each partner individually.

.03 Generally, under the unified proceedings, the TMP is the general partner designated by the partnership to represent the partnership before the Service in all tax matters for a specific taxable year. *See* section 301.6231(a)(7)-1T of the Temporary Regulations on Procedure and Administration for the rules concerning the designation of the TMP. In addition to facilitating administrative proceedings, the TMP has the authority to extend the statutory period for assessment of tax based upon partnership items for all partners, and to choose the forum for judicial review of adjustments to partnership items. The TMP also has the authority to enter into a binding settlement agreement for certain partners who, under section 6223 of the Code, are not entitled to notice of administrative proceedings (nonnotice partners). *See* section 6224(c)(3).

.04 Section 6231(a)(7)(A) of the Code provides that the TMP of any partnership is the general partner designated by the partnership as the TMP in the manner provided in regulations. Section 6231(a)(7)(B) provides that if there is no general partner who has been so designated, the TMP is the general partner having the largest profits interest in the partnership at the close of the taxable year involved (or, if there is more than one such partner, the one whose name appears first in an alphabetical listing). Section 6231(a)(7) provides further that if there is no general partner designated as the TMP and the Secretary determines that it is impracticable to apply the largest profits interest rule, the partner selected by the Secretary shall be the TMP. The Service will consider it impracticable to apply the largest profits interest rule under the circumstances described in section 3.03 of this revenue procedure.

.05 Under section 301.6231(a)(7)-1T(b)(1) of the temporary regulations, the partnership may designate a person as the TMP for a taxable year only if that person was a general partner in the partnership at some time during the taxable year for which the designation is made, or is a general partner in the partnership as of the time the partnership makes the designation. However, (1) if the partnership fails to designate a TMP, or if a prior designation has been terminated under section 301.6231(a)(7)-1T(l) and the partnership has not made a subsequent designation, and (2) if the Service determines that it is impracticable to apply the largest profits interest rule, the Service may select as the TMP for the taxable year any person who was a partner, including a person who was a limited partner, at some time during the taxable year.

SEC. 3. APPLICATION

DETERMINATION OF LARGEST PROFITS INTEREST

.01 For purposes of applying the largest profits interest rule of section 6231(a)(7)(B) of the Code and section 301.6231(a)(7)-1T(m)(2) of the temporary regulations, the Service will determine the general partner with the largest profits interest based on the year-end profits interests reported on the Schedules K-1 filed with the partnership income tax return for the taxable year for which the selection is being made. *See* section 6223(c)(1).

.02 Under section 301.6231(a)(7)-1T(m)(3) of the temporary regulations, each general partner whose selection as TMP would be immediately terminated because of the occurrence of one or more of the events described in section 301.6231(a)(7)-1T(l)(1) through (4) is treated as having a zero profits interest for that taxable year for purposes of applying the largest profits interest rule. Those events are as follows:

(1) The death of the designated TMP;

(2) An adjudication by a court of competent jurisdiction that the individual designated as the TMP is no longer capable of managing the individual's person or estate;

(3) The liquidation or dissolution of the TMP, if the TMP is an entity; and

(4) The treatment of partnership items of the TMP as nonpartnership items under section 6231(c) of the Code (relating to special enforcement areas). This includes being under investigation by the Criminal Investigation Division and being so notified, being assessed income tax under section 6851 (relating to termination assessments) or section 6861 (relating to jeopardy assessment); or being named a debtor in a bankruptcy proceeding.

WHEN DEEMED IMPRACTICABLE

.03 The Service will consider it impracticable to apply the largest profits interest rule of section 301.6231(a)(7)-1T(m) of the temporary regulations if on the date that the rule is applied,—

(1) The general partner with the largest profits interest is not apparent from the Schedules K-1 and is not otherwise readily determinable;

(2) Each general partner is deemed to have a zero profits interest under section 301.6231(a)(7)-1T(m)(3) of the temporary regulations because of the occurrence of one or more of the events described in section 301.6231 (a)(7)-1T(l)(1) through (4); or

(3) The general partner with the largest profits interest determined under section 301.6231(a)(7)-1T(m) of the temporary regulations—

(a) Has been notified of suspension from practice before the Service;

(b) Is incarcerated;

(c) Is residing outside the United States, its possessions or territories; or

(d) Cannot be located or cannot perform the functions of a TMP for any reason. Lack of cooperation with the Service by a general partner with the largest profits interest is not a basis for finding that the partner cannot perform the functions of a TMP.

SELECTION OF TMP WHEN IMPRACTICABLE TO APPLY LARGEST PROFITS INTEREST RULE

.04 If it is impracticable under section 30.03(1) of this revenue procedure to apply the largest profits interest rule of section 301.6231(a)(7)-1T(m)(2) of the temporary regulations, the Service will select as the TMP any person who was a general partner at any time during the taxable year under examination, in accordance with the notification procedures set forth in sections 3.09 through 3.11.

.05 If it is impracticable under section 3.03(2) of this revenue procedure to apply the largest profits interest rule, the Service will select a limited partner as the TMP in accordance with the criteria set forth in section 3.07. The Service will notify both the partner selected and the partnership of its selection, effective as of the date specified in the notice.

.06 If it is impracticable under section 3.03(3) of this revenue procedure to apply the largest profits interest rule, the Service will treat each general partner who fits the criteria contained in section 3.03(3) as having a zero profits interest for the taxable year, and will select a TMP from the remaining persons who were general partners anytime during the taxable year in accordance with the notification procedures set forth in sections 3.09 through 3.11. However, if all such general partners during the taxable year either (1) are treated as having zero profits interest for the taxable year under section 301.6231 (a)(7)-1T(m)(3) of the temporary regulations, or (2) are described in section 3.03(3), the Service will select a limited partner as the TMP in accordance with the criteria set forth in section 3.07 of this revenue procedure. The Service will notify both the partner selected and the partnership of its selection, effective as of the date specified in the notice.

CRITERIA FOR SELECTION OF A LIMITED PARTNER AS TMP

.07 The Service will select a limited partner as the TMP only if the limited partner was a partner in the partnership at the close of the taxable year under examination.

The Service may also consider the following criteria in selecting a limited partner as the TMP:

(1) The general knowledge of the limited partner in tax matters and the administrative operation of the partnership;

(2) The limited partner's access to the books and records of the partnership;

(3) The profits interest held by the limited partner;

(4) The views of the partners having a majority interest in the partnership regarding the selection;

(5) Whether the limited partner is a member of the partnership at the time the TMP selection is made; and

(6) Whether the limited partner is a United States person.

.08 The partnership cannot designate a limited partner to serve as TMP in lieu of a limited partner selected by the Service.

NOTIFICATION OF PARTNERSHIP

.09 The group manager of the agent examining the partnership will select the new TMP.

.10 Before selecting a general partner as TMP under sections 3.04 or 3.06 of this revenue procedure, the Service will notify the partnership by mail that after 30 days from the date of such notice the Service will make a determination that it is impracticable to apply the largest profits interest rule, and will select the TMP unless a prior designation is made by the partnership. This delay in making the determination will permit the partnership to designate a TMP under the regulations, thereby avoiding a selection made by the Service.

.11 If the Service selects a TMP, the Service will notify both the partner selected and the partnership of its selection, effective as of the date specified in the notice.

.12 During the 30-day period and prior to a TMP designation by the partnership, the Service will communicate with the partnership by sending all correspondence or notices to "The Tax Matters Partner" in care of the partnership, at the partnership's address.

.13 Any subsequent designation of a TMP by the partnership after the 30-day period will become effective as provided under section 301.6231 (a)(7)-1T(k)(2) of the temporary regulations.

SEC. 4. EFFECTIVE DATE

This revenue procedure is effective for selections made on or after March 30, 1988, (30 days after February 29, 1988, the date of publication), for all partnership taxable year that begin after September 3, 1982. It is also applicable to partnership taxable years that begin on or before and end after September 3, 1982, if the partnership, each partner, and each indirect partner requests application of Title IV of TEFRA and the Secretary consents.

---

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, Section 6212; 301.6212-1.)

Rev. Proc. 88-17

SECTION 1. PURPOSE

This revenue procedure provides taxpayers with instructions for entering into an agreement under section 6212(d) of the Internal Revenue Code to rescind a notice of deficiency. Section 6212(d) of the Code provides that the Secretary may, with the consent of the taxpayer, rescind any notice of deficiency mailed to the taxpayer. Section 6212(d) was added to the Code by the Tax Reform Act of 1986, section 1562(a), 1986-3 (Vol. 1) C.B. 678.

SEC. 2. BACKGROUND

.01 Section 6212(a) of the Code provides that if the Secretary determines that there is a deficiency in respect of any tax imposed by subtitle A of title 26 (relating to income taxes), subtitle B (relating to estate, gift, and generation-skipping taxes), or chapters 41, 42, 43, 44, or 45 (relating to certain excise taxes), the Secretary is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail.

.02 Section 6212(c)(1) of the Code provides, in general, that if the Secretary has mailed to the taxpayer a notice of deficiency as provided in section 6212(a), and the taxpayer files a petition with the Tax Court within the time prescribed in section 6213(a), the Secretary shall have no right to determine any additional deficiency, except in the case of fraud, and except as provided in section 6214(a) (relating to assertion of greater deficiencies before the Tax Court), in section 6213(b)(1) (relating to mathematical or clerical errors), in section 6851 (relating to termination assessments), or in section 6861(c) (relating to the making of jeopardy assessments).

.03 Section 6213(a) of the Code states that within 90 days, or 150 days if the notice is addressed to a person outside the United States, after the notice of deficiency authorized in section 6212 is mailed, the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. Except as provided in sectio 6851 or 6861, no assessment of a deficiency and no levy or proceeding in court for its collection shall be made, begun, or prosecuted until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day or 150-day restriction period, as the case may be, nor, if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final.

.04 Section 6212(d) of the Code provides that the Secretary may, with the consent of the taxpayer, rescind any notice of deficiency mailed to the taxpayer. Any notice so rescinded shall not be treated as a notice of deficiency for purposes of section 6212(c)(1) (relating to further deficiency letters restricted), section 6213(a) (relating to restrictions applicable to deficiencies and petition to Tax Court), and section 6512(a) (relating to limitations in case of petition to Tax Court), and the taxpayer shall have no right to file a petition with the Tax Court based on such notice.

SEC. 3. SCOPE AND OBJECTIVE

.01 This revenue procedure applies to agreements to rescind a notice of deficiency mailed to a taxpayer pursuant to section 6212(a) of the Code. This procedure does not apply to a Notice of Final Partnership Administrative Adjustment (FPAA) or to a Notice of Final S Corporation Administrative Adjustment (FSAA).

.02 Whether a notice of deficiency will be rescinded is discretionary on the part of the Secretary. A notice of deficiency may only be rescinded with the consent of the taxpayer.

.03 If a notice of deficiency is rescinded, it is treated as if it never existed. Limitations regarding credits, refunds, and assessments relating to the rescinded notice are void and the rights and obligations of the parties that existed prior to the issuance of the notice of deficiency are reinstated. The Commissioner or his or her delegate may issue a later notice of deficiency in an amount that exceeds, is the same as, or is less than the amount in the rescinded notice of deficiency. The taxpayer may exercise all administrative and statutory appeal rights from a reissued notice of deficiency, but cannot petition the Tax Court from a rescinded notice of deficiency.

.04 A notice of deficiency may be rescinded for the following reasons:

(1) If the notice was issued as a result of an administrative error; for example, the notice was issued (i) to the wrong taxpayer, (ii) for the wrong tax period, or (iii) without considering a properly executed Form 872, Consent to Extend the Time to Assess Tax.

(2) If the taxpayer submits information establishing the actual tax due to be less than the amount shown in the notice.

(3) If a taxpayer specifically requests a conference with the Appeals Division for the purpose of entering into settlement negotiations. However, the notice may be rescinded only if the Appeals Division first decides that the case is susceptible to agreement.

.05 Notwithstanding section 3.04, the Internal Revenue Service will not rescind a notice of deficiency if:

(1) On the date of the rescission, 90 days or less would remain before the expiration date of the period of limitation on assessment (determined, for this purpose, without regard to the issuance of the notice of deficiency). A notice of deficiency may be rescinded in these circumstances, however, if before that expiration date the taxpayer and the Service execute a consent to extend the limitation period on Form 872. In no case will the Service rescind a notice if, on the date of the rescission, the period of limitation on assessment would have expired but for the issuance of the notice of deficiency;

(2) The 90-day or 150-day restriction period under section 6213(a) of the Code has expired without the taxpayer filing a petition with the Tax Court;

(3) The taxpayer has filed a petition with (or mailed a petition to) the Tax Court; or

(4) The taxpayer and the Service, prior to the issuance of the notice of deficiency, have executed a Form 872-A, Special Consent to Extend the Time to Assess Tax, covering any of the tax years in the notice of deficiency.

SEC. 4. PROCEDURE

.01 In all events taxpayers who wish to have a notice of deficiency rescinded should contact the person/office listed on the notice and request Form 8626, Agreement to Rescind Notice of Deficiency. Taxpayers who wish an Appeals conference (see section 3.04(3) above) should contact the person/office listed on the notice in order to find out how to contact the appropriate Appeals Office.

.02 A request to rescind a notice of deficiency should be made by the taxpayer as soon as possible after receipt of the notice because a notice will not be rescinded after the 90-day or 150-day restriction period under section 6213(a) of the Code has expired.

.03 If the Service agrees with the taxpayer that the notice of deficiency should be rescinded, Form 8626 will be sent to the taxpayer requesting the taxpayer's written consent to rescind. If appropriate, Form 872 will also be sent for the taxpayer's signature. If the taxpayer agrees to the rescission of the notice of deficiency, the signed Form 8626 (and Form 872 if appropriate) must be returned to the office that sent the Form 8626 as soon as possible prior to the expiration of the 90-day or 150-day restriction period as described in section 2.03 of this revenue procedure. After the Form 8626 is returned by the taxpayer and signed on behalf of the Commissioner, a copy will be furnished to the taxpayer (and/or his or her authorized representative(s)) by mail or in person. The effective date of the rescission agreement is the date on which the Commissioner's delegate signs Form 8626.

.04 If the notice of deficiency was issued to a husband and wife jointly, Form 8626 and, if included, Form 872, must be signed by both the husband and wife, or their authorized representative(s). If Form 8626 and/or Form 872 is signed by a representative, and a power of attorney has not previously been filed, the power of attorney must be included with Form 8626.

.05 If the Service does not agree that the notice of deficiency should be rescinded, the taxpayer will be notified in writing and the notice of deficiency will remain in effect.

.06 Form 8626 must cover the same tax period(s) as the notice of deficiency to which it relates and must reflect the same tax deficiency and penalties as the notice of deficiency.

SEC. 5. EFFECTIVE DATE

This revenue procedure is effective with respect to notices of deficiency issued on or after January 1, 1986.

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 88-18[1]

SECTION 1. PURPOSE

To deal more efficiently with the need for guidance occasioned by the Tax Reform Act of 1986 and the Revenue Act of 1987, this revenue procedure provides conditions under which the Associate Chief Counsel (Technical and International) will consider requests for letter rulings pending the adoption of either temporary or final regulations. The objective of these changes is to expand the letter rulings process so that the Service will be able to issue rulings that previously would have been precluded by the provisions of section 5.07(2) of Rev. Proc. 88-1, page 557, this Bulletin.

SEC. 2 PROCEDURE

.01 Section 5.07(2) of Rev. Proc. 88-1 is modified to except from its conditions all Code sections added or revised by the Tax Reform Act of 1986 or the Revenue Act of 1987.

.02 For Code sections described in section 2.01 above, the appropriate Branch in Technical and International will entertain all ruling requests and do its best to issue a ruling. However the Service reserves in all cases the right not to rule when the issue cannot be properly resolved in advance of regulations.

.03 When the Service has closed a regulations project (see, for example, the extensive list published in IR 86-167, dated December 9, 1986) or does not intend to open a regulations project (see list below), section 5.07 of Rev. Proc. 88-1 does not apply and the appropriate Branch will entertain all ruling requests unless the issue is covered by the no-rule provisions of section 7 of Rev. Proc. 88-1 or by Rev. Proc. 88-3, page 579, this Bulletin, or later updates of these two revenue procedures. The following is a partial list of Tax Reform Act of 1986 Code sections for which a tentative decision has been made not to open up a regulations project:

IRC SECTION(S)	TRA-86 SECTION(S)	SUBJECT
38, 46	212	Effective 15-year Carryback of Existing Carryforwards of Steel Companies
38, 46	213	Effective 15-year Carryback of Existing Carryforwards of Qualified Farmers
48(1)	421	Extension of the Energy Investment Credit for Solar, Geothermal, Ocean Thermal, and Biomass Property
49	211	Repeal of Regular Investment Tax Credit
51	1701	Extension and Revision of Targeted Jobs Credit
162	142	Expenditures for meals, travel, and entertainment
301,302,1059	614(e)	Reduction of Stock Basis for Untaxes Portion of Extraordinary Dividends
332, 338	1804(e)(6) and (8)	80-percent Voting and and Value Test
	1804(g)	Recognition of Gain on Distribution of Property in a Reorganization
451(f)	821	Utilities Using Accrual Accounting
469	502(c)	Transition Rule for Low-Income Housing
832(b)	1021(c)	Inclusion in Income of 20 Percent of Unearned Premium Reserve
1092	331	Straddles—Year End Rule
1254	413	Gain from Disposition of Interest in Oil, Gas, Geothermal, or Other Mineral Properties
1504(a)	1804(e)(4)	Exception for Alaska Native Corporations to File Consolidated Income Tax Returns Without Equity Ownership in Subsidiaries

---

[1] Also released as News Release IR-88-79, dated April 21, 1988.

.04 The following is a partial list of Revenue Act of 1987 Code sections for which a tentative decision has been made not to open a regulation project:

IRC SECTION(S)	RA-87 SECTIONS	SUBJECT
11(b)	10224(a)	Benefits of graduated corporate rates not allowed to personal service corporations
21(b)	10101	Dependent care credit;overnight camps
51(c)	10601	Targeted jobs credit; wages during labor disputes
56(a)(6)	10202(d)	Minimum tax: Installment sales of certain property
56(f)(2)	10243	Treatment of mutual life insurance co. policy holder dividends for purpose of book income
81	10201(b)(1)	Repeal of section 81, relating to vacation pay
243 245(c)(1) 246(b) 246A(a)(1) 805(a)(4)(B) 854(b)(1)(A) 861(a)(2)	10221	Reduction in dividends received deduction for dividends from corporations not 20 percent owned
463	10201(a)	Repeal of section 463, relating to vacation pay
2001(c)	10401	5-year extension of existing rates; phaseout of benefits of existing rates and unified credit
4121(e)(2)	10503	Extension of temporary increase in amount of tax imposed on coal producers
4251(b)	10501	Extension of telephone excise tax
—	10511	Fees for request for ruling, determination, and similar

.05 The appropriate Branch Chief will discuss with taxpayers or their representatives whether a ruling concerning any Code section not listed above can be issued.

SEC. 3. USER FEE

.01 Section 4.05 of Rev. Proc. 88-8, page 628, this Bulletin, as modified by Rev. Proc. 88-13, page 639, this Bulletin, provides generally that all requests for rulings received after February 1, 1988, must be accompanied by a check or money order, payable to the Internal Revenue Service, in the appropriate amount.

.02 Each request for a ruling submitted under the instant revenue procedure and pursuant to Rev. Proc. 88-1 or Rev. Proc. 87-4, 1987-1 C.B. 529, should be sent to the Internal Revenue Service, Associate Chief Counsel (Technical and International), Attention: CC:IND:D:C, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044; Requests may be hand-delivered to Room 6561, 1111 Constitution Avenue, N.W., Washington, D.C.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 88-1 is modified.

Rev. Proc. 87-7, 1987-1 C.B. 542, is superseded.

SEC. 5. EFFECTIVE DATE

This revenue procedure is effective for requests received prior to May 16, 1988, the date of its publication in the Internal Revenue Bulletin, as well as to those received thereafter.

---

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, Section 472; 1.472-2.)

Rev. Proc. 88-19

SECTION 1. PURPOSE

This revenue procedure declares obsolete certain revenue procedures relating to the financial conformity requirement that applies to taxpayers using the last-in, first-out (LIFO) inventory identification method of accounting.

SEC. 2. BACKGROUND

.01 Section 472(c) of the Internal Revenue Code requires a taxpayer using the LIFO method to use no procedure other than the LIFO method as specified in section 472(b)(1) and (3) in inventorying its goods to ascertain the income, profit, or loss of the first tax year for which the LIFO method is to be used, for the purpose of a report or statement covering such tax year to shareholders, partners, or other proprietors, or to beneficiaries, or for credit purposes. Section 472(e) extends this conformity requirement to subsequent tax years.

.02 T.D. 7756, 1981-1 C.B. 316, published in the Federal Register on January 22, 1981, amended section 1.472-2—(e) of the Income Tax Regulations and prescribed comprehensive new rules for complying with the LIFO conformity requirement set forth in section 472—(c) and (e) of the Code. Generally, section 1.472-2(e) as amended by T.D. 7756 applies to tax years beginning after December 31, 1953, and ending after August 16, 1954.

SEC. 3. APPLICATION

Because of the amendments to section 1.472-2(e) of the regulations by T.D. 7756, the eleven revenue procedures listed in section 4 of this revenue procedure are obsolete.

SEC. 4. EFFECT ON OTHER DOCUMENTS

The following revenue procedures are obsolete:

Rev. Proc. 72-29,	1972-1 C.B.	757
Rev. Proc. 73-37,	1973-2 C.B.	501
Rev. Proc. 75-10,	1975-1 C.B.	651
Rev. Proc. 75-22,	1975-1 C.B.	717
Rev. Proc. 76-3,	1976-1 C.B.	542
Rev. Proc. 76-5,	1976-1 C.B.	543
Rev. Proc. 77-7,	1977-1 C.B.	540
Rev. Proc. 77-33,	1977-2 C.B.	542
Rev. Proc. 77-46,	1977-2 C.B.	579
Rev. Proc. 78-39,	1978-2 C.B.	542
Rev. Proc. 79-37,	1979-2 C.B.	500

Rev. Proc. 88-20

SECTION 1 Electronic Returns

.01 Overview

1 This revenue procedure sets the specifications for the Electronic Filing of Tax Year 1987 Individual Income Tax Returns in 1988. It also provides the specifications for the optional Direct Deposit of refunds on electronically filed returns. Participants in 1987 must reapply for approval to participate in 1988.

2 To participate in 1988, filers must complete an application form and agree to follow all requirements and specifications in this revenue procedure. They must also successfully complete testing and be accepted in the program by January 15, 1988. The data for the test will be provided by the Service.

3 The Service reserves the right to revoke the electronic filing privilege of any electronic filer who varies from these requirements and specifications or who does not consistently transmit error-free returns.

4 Approval to participate will be for 1988 only. Specifications and application procedures for processing year 1989 will be issued in 1988.

5 The number of areas from which electronic returns will be accepted has been expanded from seven metropolitan areas to sixteen IRS districts, ten of which comprise entire states. In addition, taxpayers from all participating districts who file electronically can elect to have their refunds directly deposited into their accounts in financial institutions.

6 For 1988, most widely-used forms and schedules and selected forms developed as a result of the Tax Reform Act of 1986 will be accepted. Electronic returns will be transmitted to either the Cincinnati or the Ogden Service Center.

7 Participants will electronically transmit returns to the Internal Revenue Service over communications lines and will retain related paper documents (taxpayer declarations, copies of Forms W-2, etc.) for weekly submission.

.02 Composition of an Electronic Return

1 An electronic return consists of data transmitted to the Service electronically and of paper documents filed with the Service at a later date which contain information which cannot be electronically transmitted, such as taxpayer signatures, documents prepared by third parties, etc. In total, an electronic return contains the same information as a comparable return filed entirely on paper documents.

2 For 1988, electronically transmitted data is limited to entries from the forms and schedules listed below. Selected data from Forms W-2, W-2P and W-2G will be transmitted electronically; the paper copies will be sent to the Service as attachments to the Forms 8453, U.S. Individual Income Tax Declarations for Electronic Filing. All other schedules and forms listed are to be filed with the Service in electronic form only.

3 The non-electronic portion of the return consists of the following:

(a) Form 8453, U.S. Individual Income Tax Declaration for Electronic Filing, is required for all electronic returns. See Section 5 and Attachment I of these instructions.

(b) Copy B of Forms W-2, W-2P, or W-2G which would normally be attached to the front of a return filed entirely on paper documents. Instead, these will be attached to the front of the Form 8453 overlaying Part II.

(c) Other documents containing required signatures, such as Form 2120 (Multiple Support Agreement), a physician's statement as required to support an entry on Schedule R, a proof of blindness certification from a physician or registered optometrist, an Exemption for Non-Custodial Parent (Form 8332), Form 8283, Page 2, Appraisal Summary, etc.

(d) Any other documents which

(1) are not required by the Service,

(2) are not IRS forms or schedules,

(3) are not covered in subparagraph (c) above, or

(4) are voluntarily being included with the return by the taxpayer as supporting material.

(e) Also, in certain instances, a signed copy of the paper tax return will have to be attached. (See Section 7.03.)

4 The non-electronic material must be stapled together, with the Taxpayer Declaration (Form 8453) on top, followed sequentially by the material described in Section 1.02, paragraph 3(c),

Form 1040, U.S. Individual Income Tax Return
* Form 1040A, U.S. Individual Income Tax Return
* Form 1040EZ, Income Tax Return for Single filers with no dependents
    Schedule A, Itemized Deductions
    Schedule B, Interest and Dividend Income
    Schedule C, Profit or (Loss) From Business or Profession
    Schedule D, Capital Gains and Losses and Reconciliation of Forms 1099-B
    Schedule E, Supplemental Income Schedule
    Schedule R, Credit for the Elderly or for the Permanently and Totally Disabled
    Schedule SE, Computation of Social Security Self- Employment Tax
Form W-2, Wage and Tax Statement
Form W-2P, Statement for Recipients of Annuities, Pensions, Retired Pay or IRA Payments (when there is tax withholding)
Form W-2G, Statement for Recipients of Certain Gambling Winnings
Form 2106, Employee Business Expenses
Form 2119, Sale or Exchange of Principal Residence
Form 2441, Credit for Child and Dependent Care Expenses
Form 3903, Moving Expenses
Form 4562, Depreciation and Amortization
Form 6198, Computation of Deductible Loss From an Activity Described Section 465(c)
Form 6251, Alternative Minimum Tax -Individuals
Form 6252, Computation of Installment Sale Income
Form 8283, Noncash Charitable Contributions
** Form 8582, Passive Activity Loss Limitations
** Form 8598, Home Mortgage Interest
** Form 8606, Nondeductible IRA Contributions, IRA Basis, and Nontaxable IRA Distributions

* Note: Taxpayers who would normally file Form 1040A or Form 1040EZ can participate. However, these returns must be filed electronically in the format of a Form 1040.

** These forms were developed as a result of the Tax Reform Act of 1986 and are included in the 1988 program.

then the material in paragraphs 3(d) and 3(e).

5 Electronic filers will be tested on all forms and schedules that they intend to file from those listed in Section 1.02, paragraph 2, and must successfully complete a test transmission of these forms.

6 The electronic return must be an overpaid return, i.e., the credits and prepayments reported on the return must exceed the total tax due. The overpaid amount can be refunded by check, directly deposited in the taxpayer's financial institution account or applied to 1988 estimated tax. The overpaid amount can be split two ways at the taxpayers'option. Part of it can be applied to 1988 estimated tax and the remainder refunded by check; or, part of it applied to 1988 estimated tax and the remainder directly deposited. If the amount of the overpayment is changed due to a math error, offset, etc., the estimated tax allocation has priority over the Direct Deposit or refund check allocation.

7 When an electronic filer charges a separate fee for the electronic transmission of the return, this fee must not be based on a percentage of the refund amount.

.03 Exclusions

1 The following types of returns are excluded from electronic filing in 1988.

(a) Returns without an overpayment, such as even balance, balance due or with remittance returns.

(b) Decedent returns, including joint returns filed by surviving spouses.

(c) Returns with a Power of Attorney currently in effect for the refund to be sent to a third party.

(d) Amended or Corrected returns (even if the return being amended was filed electronically). Only one tax year 1987 electronic return can be filed for any taxpayer.

(e) Returns containing forms or schedules not listed in paragraph 2 of Section 1.02 above.

(f) Returns for any tax period other than January 1, 1987 to December 31, 1987.

(g) Returns transmitted electronically by filers not accepted by the Service for electronic filing.

(h) Returns transmitted after April 15, 1988, even if the taxpayer has secured an extension.

(i) Returns subject to community property rules, with filing status "married filing separately".

(j) Returns containing multiple Schedules E, or more than three rental properties on a Schedule E.

(k) Returns with dollars and cents entries (whole dollars only accepted).

(l) Returns claiming a Mortgage Interest Credit or a Carryover Residential Energy Credit on Line 42 of Form 1040.

(m) Returns containing more than 20 pages ofcontinuation statements. (See Electronic Return File Specifications.)

(n) Returns containing more than three Schedules C.

(o) Returns containing more than one Schedule SE per taxpayer.

(p) Returns containing more than one Form 2119.

(q) Returns containing more than three Forms 4562.

(r) Returns containing more than three Forms 6252.

(s) Returns containing more than two Forms 2106.

(t) Returns containing more than three Forms 6198.

(u) Returns containing more than two Forms 8606.

(v) Returns containing more than one Form 8582.

(w) Returns which require special consideration or procedures for completion, such as returns for taxpayers who have received waivers from the IRS.

SEC. 2 Eligibility Requirements

.01 A participating electronic filer must meet the following qualifications to be accepted:

1 intend to electronically transmit at least 100 tax year 1987 returns in 1988.

NOTE: If you intend to transmit fewer than 100 returns, you must transmit through another accepted electronic filer or through an accepted service bureau.

2 have substantial communication experience under IBM 3780 RJE bisynchronous or CCITT X.25 (1980) protocols at 4800 BAUD through a dial-up modem or associate with another firm which has such experience.

3 have an office in one or more of the designated IRS districts included for 1988. (See Section 2.02.)

NOTE: Software firms, communications firms, and service bureaus who plan to develop packages for use by participating electronic filers do not need to be located within one of the designated districts.

4 comply with the acceptance procedures in Section 4.

5 observe all requirements of this revenue procedure.

.02 Electronic returns are only prepared or accepted from tax preparation offices within the geographical boundaries of the following IRS districts and must be transmitted to the designated service center.

.03 While there is no geographic restriction on the taxpayers participating in electronic filing, active solicitation of business outside the designated districts is prohibited. Taxpayers who reside outside of the designated districts must appear in person at a preparer's office within the designated districts.

SEC. 3 Advertising Standards

.01 Advertising Restrictions

Preparers/transmitters of electronic returns, with respect to their capability to file returns electronically, shall comply with the advertising and solicitation provisions of 31 C.F.R. Part 10 (Treasury Department Circular No. 230). Such provisions prohibit the use in any way or participation in the use of any form of public communication containing a false, fraudulent, misleading, deceptive, unduly influencing, coercive or unfair statement or claim. The prohibition includes, but is not limited to, statements pertaining to the quality of services rendered unless subject to factual verification, claims of specialized expertise not authorized by State or Federal agencies having jurisdiction over the preparer/transmitter, and statements or suggestions that the ingenuity and/or prior record of a preparer/transmitter rather than the merit of the matter are principal factors likely to determine the result of the matter. In addition, advertising must not imply a special relationship with the Internal Revenue Service (IRS), the Financial Management Service (FMS) or the Treasury Department. Claims for faster refunds by virtue of electronic filing must be consistent with the language in official Service publications.

.02 Media Communications

Communications, including fee information, shall be limited to professional lists, telephone directories, print media, permissible mailings, radio and television. In the case of radio and television broadcasting, the broadcast shall be pre-recorded and the practitioner shall retain a recording of the actual audio transmission.

.03 Geographic Limits

A preparer/transmitter shall not advertise electronic filing in a publication or broadcast whose primary recipients or audience are located outside the designated districts. It is understood that the preparer/transmitter cannot limit the broadcasting of advertisements or distribution of publications to areas within the geographical location requested. However, the primary broadcasting or distribution area must be within one of the approved district areas.

.04 IRS or FMS Endorsement Must Not Be Implied

Acceptance to participate in the program *does not imply* endorsement by the Internal Revenue Service or the Financial Management Service of the software or quality of services provided. Therefore, any public communication in which a participant's electronic filing and/or Direct Deposit capabilities are referenced whether through publication or broadcast, *must* clearly indicate that IRS acceptance of the participant for electronic filing and/or Direct Deposit does not constitute an endorsement or approval of the

District Office	*Areas Included*	*Service Center*
Albany, NY	Counties of Albany, Clinton, Columbia, Dutchess, Essex, Franklin, Fulton, Greene, Hamilton, Montgomery, Orange, Putnam, Rensselaer, Saratoga, Schenectady, Schoharie, St. Lawrence, Sullivan, Ulster, Warren and Washington	Cincinnati
Birmingham, AL	Entire State of Alabama	Cincinnati
Buffalo, NY	Counties of Allegany, Broome, Cattaraugus, Cayuga, Chautaugua, Chemung, Chenango, Cortland, Delaware, Erie, Genesee, Herkimer, Jefferson, Lewis, Livingston, Madison, Monroe, Niagara, Oneida, Onondaga, Ontario, Orleans, Oswego, Otsego, Schuyler, Seneca, Steuben, Tioga, Tompkins, Wayne, Wyoming and Yates	Cincinnati
Cincinnati, OH	Counties of Adams, Athens, Brown, Butler, Clark, Clermont, Clinton, Coshocton, Delaware, Fairfield, Fayette, Franklin, Gallia, Greene, Guernsey, Hamilton, Highland, Hocking, Jackson, Knox, Lawrence, Licking, Madison, Marion, Meigs, Miami, Montgomery, Morgan, Morrow, Muskingum, Noble, Perry, Pickaway, Pike, Preble, Ross, Scioto, Union, Vinton, Warren and Washington	Cincinnati
Dallas, TX	Counties of Anderson, Andrews, Angelina, Archer, Armstrong, Bailey, Baylor, Borden, Bowie, Briscoe, Brown, Callahan, Camp, Carson, Cass, Castro, Cherokee, Childress, Clay, Cochran, Coke, Coleman, Collin, Collingsworth, Comanche, Concho, Cooke, Cottle, Crane, Crockett, Crosby, Dallam, Dallas, Dawson, Deaf Smith, Delta, Denton, Dickens, Donley, Eastland, Ector, Ellis, Erath, Fannin, Fisher, Floyd, Foard, Franklin, Gaines, Garza, Glasscock, Gray, Grayson, Gregg, Hale, Hall, Hansford, Hardeman, Harrison, Hartley, Haskell, Hemphill, Henderson, Hockley, Hood, Hopkins, Houston, Howard, Hunt, Hutchinson, Irion, Jack, Johnson, Jones, Kaufman, Kent, King, Knox, Lamar, Lamb, Lipscomb, Loving, Lubbock, Lynn, Marion, Martin, Menard, Midland, Mills, Mitchell, Montague, Moore, Morris, Motley, Nacogdoches, Navarro, Nolan, Ochiltree, Oldham, Palo Pinto, Panola, Parker, Parmer, Potter, Rains, Randall, Reagan, Red River, Roberts, Rockwall, Runnels, Rusk, Sabine, San Augustine, Schleicher, Scurry, Shackelford, Shelby, Sherman, Smith, Stephens, Sterling, Stonewall, Sutton, Swisher, Tarrant, Taylor, Terry, Throckmorton, Titus, Tom Green, Upshur, Upton, Van Zandt, Ward, Wheeler, Wichita, Wilbarger, Winkler, Wise, Wood, Yoakum and Young	Ogden
Greensboro, NC	Entire State of North Carolina	Cincinnati
Indianapolis, IN	Entire State of Indiana	Cincinnati
Louisville, KY	Entire State of Kentucky	Cincinnati
Milwaukee, WI	Entire State of Wisconsin	Cincinnati
Omaha, NE	Entire State of Nebraska	Ogden
Phoenix, AZ	Entire State of Arizona	Ogden
Richmond, VA	Entire State of Virginia	Cincinnati
Sacramento, CA	Counties of Alpine, Amador, Butte, Calaveras, Colusa, Contra Costa, Del Norte, El Dorado, Glenn, Humboldt, Lake, Lassen, Marin, Medocino, Modoc, Napa, Nevada, Placer, Plumas, Sacramento, San Joaquin, Shasta, Sierra, Siskiyou, Solano, Sonoma, Sutter, Tehama, Trinity, Yolo and Yuba	Ogden
San Jose, CA	Fresno, Inyo, Kern, Kings, Madera, Mariposa, Merced, Mono, Monterey, San Benito, San Luis Obispo, Santa Barbara, Santa Clara, Santa Cruz, Stanislaus, Tulare, Tuolumne and Ventura	Ogden
Salt Lake City, UT	Entire State of Utah	Ogden
Seattle, WA	Entire State of Washington	Ogden

quality of tax preparation services provided.

.05 Advertising of Direct Deposit by Electronic Filers

1 Use of Direct Deposit name and logo.

(a) The name "Direct Deposit" will be used with initial capital letters or all capitals.

(b) The logo/graphic for Direct Deposit will be used whenever feasible in advertising/promotional copy. (See Attachment X.)

(c) The color or size of the Direct Deposit logo/ graphic can be changed when used in advertising/promotional pieces.

(d) A camera copy of the Direct Deposit logo can be obtained by writing to the Financial Management Service, 401 14th Street SW, Washinton, DC 20227, Attn: Jim Knox, Product Promotion Branch, Third Floor or by calling 202-287-0467 (not a toll-free number).

2 Use of Financial Management Service (FMS) or Treasury Seals.

(a) Advertising or promotional materials may not indicate that FMS or Treasury endorses a financial institution (FI), a trade association, a tax preparer, electronic filer, or other private sector organization.

(b) Advertising or promotional materials that indicate the cooperative nature of the project (public/private sector) must contain clear indications of names of all participating organizations.

.06 Advertising Refund Anticipation Loans

In advertising the availability of refund anticipation loans, electronic filers and financial institutions must refer to or describe the funds being advanced as loans, not refunds; i.e., they must make it clear that the taxpayer is borrowing against the anticipated refund, not securing the refund itself from the financial institution.

SEC. 4 Acceptance Procedures

.01 Applications

1 Return preparers, service bureaus, software firms or other interested parties who express interest in participating in 1988 electronic filing program will be sent an application, Form 8633, Preparer/Transmitter Application to File 1987 Individual Income Tax Returns Electronically (see Attachment II) and a draft copy of the Revenue Procedure.

2 To be considered for participation in the electronic filing program, interested parties must return a completed application form to the Service at the following address no later than September 15, 1987.

Internal Revenue Service
P. O. Box 7814
Washington, DC 20044

Attn: Electronic Filing Section
PATS Coordinator

3 If an applicant intends to file from several of the designated districts, or from several branch offices within a designated district, see subsection .02 below.

.02 Applications From Branch Offices

1 If an applicant has branch offices, (either owned by the applicant or privately-owned but licensed by the applicant) a single application must be filed covering all such offices within the district office areas identified in Section 2.02. The name, address, including county, and telephone number of a local contact in each designated branch office must be included with the application.

2 The applicant must give each privately-owned branch office a copy of this revenue procedure for electronic filing.

3 Privately-owned branch offices which are not using the hardware, software or communications network provided by the applicant or which will be transmitting from a different point of origin than the applicant and which desire to file electronically must apply individually.

.03 Testing Requirements

1 After the application has been received, the Service will provide materials to the applicant which will be used to thoroughly check out the applicant's system.

2 When applicants are ready to test with the Service, they should call the Cincinnati Service Center at 606-292-5444 or the Ogden Service Center at 801-625-6856 (not toll-free numbers) for instructions. See Sec. 2.02 for applicable service center.

3 When the same software/communications system is used by several applicants, one successful preliminary test transmission of electronic returns is required in order to test the system. However, after a software/communications system has been accepted by the Service, each applicant using that system will also be required to submit a successful test transmission prior to acceptance of each individual applicant.

.04 Acceptance

1 The Service will review the test transmission and provide feedback to the applicant. If the transmission is not correctly formatted or the applicant's test returns contain errors, the Service will identify to the applicant the errors encountered on each erroneous return. The applicant must then correct the software to eliminate the indicated errors and contact the Service to arrange for another transmission.

2 The applicant must transmit the test materials to the Service between October 5, 1987 and December 18, 1987 and must be accepted in the program by January 15, 1988. Otherwise, the applicant cannot participate in the 1988 program.

3 When the filer is accepted, the Service will issue a letter to the applicant granting official acceptance to participate in the 1988 program. Filers accepted in the program will be notified by telephone when they can begin transmitting live electronic returns. IMPORTANT: Filers are not to stockpile returns for electronic transmission prior to receiving official acceptance in the program.

SEC. 5 Taxpayer Declarations (Form 8453)

.01 Prior to submitting an electronic return, an electronic filer must obtain the taxpayer's signature on a declaration form (see Attachment I). In addition, the electronic filer must obtain all other documents currently required to be filed with returns, as detailed in Section 1.02, paragraph 3, above.

.02 The declaration will serve the following purposes.

1 Authenticate the return.

2 Authorize the electronic filer to file the return on behalf of the taxpayer.

3 Provide a transmittal for the associated paper documents that will be stapled to the declaration.

4 Authorize the electronic filer to transmit via a third-party transmitter.

5 Authorize the Service to directly deposit any overpayment to the taxpayer's account at a financial institution when specified.

.03 The electronic filer will be required to file a corrected declaration when:

1 the Total Tax field or the Refund field on the declaration differs from the corresponding amount on the return by $5 or more; or

2 the Total Income amount differs from the corresponding amount on the return by $25 or more.

.04 Electronic filers must use the official Form 8453 or an approved substitute form which duplicates the official form in format, language, contents and exact size. Electronic filers who wish to develop a substitute form must send a sample to the applicable service center Electronic Filing Unit for approval.

.05 After the Form 8453 has been properly executed, including the taxpayer and electronic filer signatures, the electronic filer will transmit the electronic portion of the return to the Service in accordance with Service specifications. By transmitting the electronic portion of the return to the Service, the electronic filer is stipulating that the declaration has been executed and that the official descriptions of all entries of the electronic return apply, i.e., retained copies do not contain any unauthorized caveats. (See Section 7 for signature requirements).

.06 The electronic filer will assign a unique 14 digitDeclaration Control Number (DCN) to each Form 8453. Its structure will be as follows:

Position	*Comments*
1–2	These two digits must be "00".
3–7	The Electronic Filer Identification Number (EFIN). This is a unique number assigned by the IRS to each participating electronic filer for each area where electronic returns are prepared. The first two digits will always be the IRS District Office code.
8–11	Sequential number assigned by the electronic filer to each batch of up to 100 returns.
12–13	Serial number of return within batches of 100 returns (00–99). For example, 00 equals the first return; 50 equals the 51st return in the batch of 100 returns.
14	This digit must be "8".

.07 The DCN must be recorded in the upper right hand corner of the Form 8453 for each taxpayer. Hyphens must appear between the 2nd and 3rd, 7th and 8th, and 13th and 14th digits.

For example: 00–12345–678900–8

.08 When a DCN has been assigned to a transmitted record, it cannot be changed. If a transmitted return record is rejected by the Service, the retransmitted return and related Form 8453 must reflect the original DCN.

.09 A listing of all DCN's contained on a return transmission must be produced which records the Declaration Control Number, the Social Security Number and Name Control from each electronic return transmitted. The DCN's on the listing must correspond with the DCN's assigned to the related Taxpayer Declarations. This listing will be used as a control document when sending Forms 8453 to the Service. Each listing should be divided into sections by the sequence number (positions 8–11) of the DCN. Each section is a Declaration Control Record for each batch of Forms 8453 and can contain a minimum of one and a maximum of 100 serial numbers (positions 12 and 13) for each sequence number of the DCN. No more than two printed pages per Declaration Control record (DCN sequence number) is allowed and no more than 50 DCN's can be contained on one page. (See Attachment III for the format of the Declaration Control Record.)

SEC. 6 Filing of Electronic Returns and Distribution of Copies

.01 The Service will advise electronic filers when they can begin to file electronic returns. Until this notification has been issued, electronic returns will not be accepted by the Service.

.02 If the electronic filing system breaks down for a potentially lengthy period, the Service will provide instructions to electronic filers.

.03 Material To Be Filed With The Service.

1 Participating electronic filers must transmit to the Service all electronic data, all taxpayer declarations, and all other materials described in Section 1.02, paragraph 3.

2 The electronic filer will maintain the documents referred to in Section 1.02, paragraph 3, in DCN order and associate them with the related Declaration Control Record.

3 Beginning on January 22, 1988, and every Friday thereafter throughout the filing period, the electronic filer will send this material to the applicable service center, in accordance with shipping instructions described in paragraphs 4 through 7 below. No Form 8453 may be sent to the Service for any electronic return that has not been acknowledged as accepted by the Service (see Section 9). Each shipment should include forms for all electronic returns filed during the previous week which have been acknowledged by the Service, e.g., materials for returns acknowledged by January 29, 1988 must be shipped by February 5, 1988.

> IMPORTANT: For returns prepared and transmitted on April 15, 1988 and accepted after April 15, 1988 to be considered timely filed, the related Forms 8453, Taxpayer Declarations, must be signed by April 15, 1988 and received in the applicable service center by April 22, 1988.

4 A Declaration Control Record, (see Attachment III) must accompany each batch of Forms 8453. If a return has been rejected or not acknowledged by the Service (see Section 9) remove the applicable Forms 8453 from the batch and line through the DCN, SSN and Name Control on the Declaration Control Record for each item removed from the batch. If rejected or unacknowledged returns are subsequently transmitted, the retransmitted record, the applicable Form 8453 and related Declaration Control Record must reflect the originally assigned DCN.

> NOTE: The Declaration Control Record must be created prior to transmitting the return file and should be reviewed thoroughly to avoid duplication of DCNs.

5 Place the Declaration Control Record at the front of the batch of Forms 8453 and secure with a rubber band or string. The paper documents in each batch must be in ascending sequence following the Declaration Control Record.

6 Prepare batches for shipping using envelopes or cartons as volume or preference dictates and send to the appropriate service center.

Internal Revenue Service
Cincinnati Service Center
200 W. 4th St.
Covington, KY 41011
Attn: Electronic Filing Unit

Stop #21

Internal Revenue Service
Ogden Service Center
P. O. Box 9941
Ogden, UT 84409
Attn: Electronic Filing Unit
Stop #1056

7 Method of delivery is optional. However, Declarations should be received at the service center within one week of shipment.

8 If a taxpayer declaration is found to be missing, the electronic filer will be required to expeditiously provide either a copy of a signed Form 8453 from his or her records (see Sec. 6.04) or obtain a new Form 8453 from the taxpayer.

.04 Material To Be Retained By The Electronic Filer

The electronic filer must retain a copy of the material furnished to the taxpayer. The copy of the electronic material (described in Section 1.02, paragraph 2) may be retained on magnetic media. In addition, the electronic filer must retain the acknowledgement file received from the Service to facilitate taxpayer inquiries. The retention period for this material must be consistent with Treasury Regulation 1.6107-1(b)(3).

.05 Material To Be Provided To The Taxpayer.

The electronic filer must furnish the taxpayer with a paper copy of all material filed with the Service covered in Section 1.02, subparagraphs 3(a), (c) and (d)(2), and any material covered in subparagraph (d)(3). In addition, the electronic filer should advise the taxpayer to retain copies of materials described in subparagraphs (b) and (d)(1) and materials described in subparagraphs (d)(3) and (d)(4) which were not provided by the electronic filer. The copy of the electronic material described in Sec. 1.02, subparagraph 2, can be contained on replicas of official forms or on forms designed by the electronic filer. If the latter, data entries must be referenced to the line numbers on official forms. Preparers should also advise taxpayers that their electronic returns will be processed by the IRS at the Cincinnati or Ogden Service Center, as applicable, but that amended returns, if needed, must be filed on paper returns and mailed to their usual IRS center.

IMPORTANT: Electronic filers will be required to give each taxpayer for whom they file an electronic return a copy of Notice 811, To Taxpayers Who Take Part in Electronic Filing, provided by the Internal Revenue Service (See Attachment IV).

SEC. 7 Electronic Filer Requirements and Responsibilities

.01 The Service will accept electronic returns only from filers who have been accepted for electronic filing.

.02 Electronic filers must not prepare returns for taxpayers who do not personally appear before them (at least one taxpayer on a joint return) unless the taxpayers are residents of one of the designated districts during the filing season.

.03 An electronic filer that accepts returns prepared by individuals or by non-participating preparers (i.e., those not approved for electronic filing) solely for purposes of electronic input will be considered to come under the "mechanical assistance" exception described in Treasury Regulation 301.7701-01(d)(1), In these cases, the filer will not be considered to be a paid preparer for purposes of IRC 7701(a)(36). In addition, the following requirements must be met:

1 The taxpayer must be physically present in the electronic filer's office.

2 The electronic filer must check the box and sign the Form 8453 as the transmitter only and obtain the taxpayer's signature on that same form.

3 The return must meet the same validation tests required for other electronic returns. However, except for the minor correction provisions in Section 7.07 below, if the electronic filer corrects any material rather than the taxpayer or incorrectly transmits any of the return data contained on the taxpayer's paper return, the electronic filer will be considered to be the return preparer. The electronic filer must sign the Form 8453 as the preparer and not check the box as the tranmitter only.

4 If the return was self-prepared by the taxpayer, one copy of the return signed by the taxpayer must be retained by the electronic filer, another copy of the Form 1040 (Page 1 and 2), Form 1040A (Page 1 and 2) or the Form 1040EZ (Page 1) must be attached to the Form 8453 and the paid preparer field on the electronic return must be left blank.

5 When an electronic filer transmits returns prepared by another firm, the other firm that prepared the return must be identified in the appropriate field of the electronic return as the paid preparer, and a copy of the Form 1040 (Page 1 and 2), Form 1040A (Page 1 and 2) or the Form 1040EZ (Page 1) signed and prepared by that other firm must be attached to the Form 8453.

.04 A firm approved for electronic filing (e.g., Firm A) can provide data processing and/or communication services to another preparer approved for electronic filing (e.g., Firm B). In these cases,

1 Firm A will be considered to come under the "mechanical assistance" exception in 301.7701-15(d)(1), and therefore will not be considered to be the paid preparer for purposes of IRC 7701(a)(36), and

2 Firm B must complete and sign the Form 8453, not Firm A.

.05 A firm not approved for electronic filing can provide data processing services to approved electronic filers. In these cases,

1 the firm providing the services will be considered to come under the "mechanical assistance" exception in 301.7701-15(d)(1), and therefore will not be considered to be the paid preparer for purposes of IRC 7701(a)(36), and

2 the electronic filer must complete and sign the Form 8453, not the servicing organization.

.06 If electronic returns are transmitted to the Service via communications company, and the communications company does not alter the return information,

1 the Service will consider the actions of the approved electronic filer as a permissible disclosure under Treas. Reg. 301.7216-2(h), and

2 the Service will consider the actions of the communications company as an "auxiliary service" under Treas. Reg. 301.7216-1(b)(2)(i)(B).

.07 If an electronic return is corrected in a non-substantive way after the taxpayer's signature has been obtained on Form 8453, but before transmission to the Service, it will not be necessary for the electronic filer to obtain the taxpayer's signature on a new Form 8453, provided the following conditions are met:

1 The corrections do not affect any of the amounts included on the Form 8453 signed by the taxpayer (subject to the tolerances described in paragraphs 1 and 2 of Section 5.03 above).

2 The non-substantive changes are limited to corrections of arithmetic errors, transposition errors, misplaced entries and spelling errors. The incorrect information should be neatly lined through on the Form 8453 and the correct data entered next to the lined-through entry. Also, enter the initials or name of the person making the correction.

Note: Dropping cents and rounding to whole dollars does not constitute a substantive change or alteration to the return. All rounding should be accomplished in accordance with the instructions in the Form 1040 tax package.

.08 After an electronic return is submitted, it cannot be recalled or intercepted in process. If either the electronic filer or the taxpayer wishes to change any entries, an amended return must be filed in the form of a paper document.

.09 Electronic filers must not contact the Service regarding corrections to specific electronic returns that have been acknowledged as accepted unless a current Power of Attorney is on file with the Service for this purpose.

.10 The electronic filer must promptly satisfy Service requests to resolve problems relating to missing or inconsistent Forms 8453 and provide copies of such forms within five workdays upon request by the Service.

.11 The electronic filer must provide Service representatives with access to all materials required to be maintained.

.12 An electronic filer whose application covers branch offices (per Section 4.02 above) must serve as a conduit between the IRS and those offices for correspondence, resolution of problems, evaluation reports, etc. Electronic filers whose branch offices are located in more than one participating district may elect to designate one contact person per district area to serve as the conduit between IRS and the offices within that district. In either case, however, if IRS needs access to retained copies of electronic returns, it will go directly to the designated local contacts. Any problems encountered by the IRS in securing such access will be reported to the electronic filer who is responsible for corrective action.

1 Electronic filers must monitor electronic filing at covered branch offices, to the extent permitted by law and regulations, to ensure compliance with all IRS requirements. To supplement this, IRS will advise electronic filers of problems it has encountered originating in the covered branch offices. Failure to take corrective action will lead to the initiation of suspension action against the electronic filer.

2 If there are repeated or continuing problems with electronic filing from a particular covered branch office, the electronic filer is required to drop that office from the electronic filing program.

3 If IRS initiates suspension action, it will apply to all returns filed by an electronic filer, including covered branches.

4 The procedures in Sec. 7.04 also apply to returns filed by privately-owned branches.

.13 The taxpayer is instructed in Notice 811 to contact the electronic filer if the refund has not been received within four weeks. In these cases, the electronic filer should verify that the Service has acknowledged acceptance of the return.

1 If the return was not acknowledged as accepted by the Service, the electronic filer must immediately advise the taxpayer that the return was not filed, and if directed by the taxpayer, retransmit the return. Otherwise, a paper return must be filed by the taxpayer.

2 If the return was acknowledged as accepted by the Service, but less than four weeks have elapsed since the date of the acknowledgement, the electronic filer should advise the taxpayer to wait four weeks from the acknowledgement date before making another inquiry.

3 If the return was acknowledged as accepted by the Service and four or more weeks have elapsed since the date of the ackowledgement, the electronic filer should advise the taxpayer to contact their local IRS district for assistance.

SEC. 8 Electronic Filing Communications Requirements

.01 These procedures will only apply to the 1988 program and may not be relevant in subsequent years.

.02 Returns can be transmitted by preparers or by communications firms acting for preparers. For purposes of this section both will be termed transmitters. Normally, all data communications will be over the Public Switched Telephone Network to the Cincinnati or Ogden Service Center. However, if transmitters wish to avail themselves of a dedicated (9600 baud) line, they must make a written request (letter) to Director, IS:I, Rm. 3407 ARFB, 1111 Constitution Ave. NW, Washington, DC 20224 by October 15, 1987. Telephone numbers, specific password conventions and a test transmission schedule will be developed between the IRS and transmitters at a later time.

.03 All data communications between transmitters and the Service will be accomplished using the following requirements:

1 Line Speed

(a) 4800 BPS via Public Switched Telephone Network

(b) 9600 BPS via dedicated facility provided by the transmitter.

2 Character Code

(a) Extended Binary Coded Decimal Interchange Code (EBCDIC)

(b) American Standard Code for Information Interchange (ASCII)

3 Communications Protocols

(a) IBM 3780 RJE bi-synchronous (BSC).

(b) Packet-Switching Network Interface Standard as defined by the CCITT Recommended X.25(1980)

NOTE: Other protocols may become available. Contact the EFS Data Communications Coordinator, (202) 377-9390, for the latest list.

4 Modems

(a) All dial-up will be 4800 BPS Bell 208B compatible.

(b) For 9600 BPS dedicated lines, the modem will be provided by the electronic filer/ transmitter.

.04 Transmitters will be responsible for the security of all transmitted data. Transmittals will not be considered filed returns until they successfully pass through the IRS Electronic Filing Pre-Processor.

.05 The receipt date of the electronic transmission will constitute the receipt date of the return if it is acknowledged as accepted by IRS.

.06 Returns Prepared on April 15th.

1 The determination of whether an electronic return is timely filed is made in the same way as for paper returns.

2 If by April 18th, an acknowledgement of acceptance has not been received for any timely transmitted return, the electronic filer must immediately contact the Electronic Filing Unit at the applicable service center. If the situation is not resolved, the filer must advise the taxpayer that the return

was not filed and that a paper return should be mailed directly to the IRS. In addition, the preparer should tell the taxpayer to attach a brief note of explanation to the return, containing the name and Employer Identification Number of the preparer/ transmitter and stating that the return is late due to rejection of a timely submitted electronic return.

SEC. 9 Acknowledgement of Electronically Filed Returns

.01 Each transmission of a file of electronic returns will normally be acknowledged to the transmitter within two workdays of successful receipt. Any return not acknowledged as received by the Service will be considered not filed.

.02 The transmitter should immediately match the acknowledgement file back to the original file transmitted. Any tax return transmitted which is not acknowledged by the Service has not been accepted for processing and must be resubmitted to be considered a filed return.

.03 The acknowledgement file identifies which returns have been accepted, rejected or identified as duplicates. Rejects will be coded as internal inconsistencies, control data errors or key field data errors. (See Electronic Return File Specifications.)

.04 When a return has been rejected after three attempts, contact the appropriate service center Electronic Filing Unit.

Note: Any transmitter who does not receive transmission of an Acknowledgement File within two workdays or who receives acknowledgements for returns which were *not transmitted on the designated transmission* should immediately contact the appropriate service center.

SEC. 10 Overview of Transmission Procedures

(See Electronic Return File Specifications and Electronic Return Record Layouts for all record formats.)

.01 The following sequence of events will constitute a taxreturn data transmission session:

1 The electronic filer will telephone the Service Center's MODEM (on the authorized telephone numbers only) and initiate the authentication process. When the transmitter has been authenticated, a tax return data session will commence. During the session, two types of transmissions can occur.

2 The first transmission will be an acknowledgement by the IRS of previous session transmittals by the electronic filer, if appropriate. Acknowledgement Files will be available within two workdays of receipt of the tax return transmission (see Section 9 for a description of the Acknowledgement File). Upon interfacing with the IRS Electronic Filing System (EFS) computer, the EFS will transmit an acknowledgement of validated tax return records, or a screen announcement of the lack of an acknowledgement file. At the termination of the first transmission, the EFS will proceed to accept the transmission of new return records. The electronic filer may receive return acknowledgements without transmitting new tax return data.

3 The second transmission, without a break in the communication link, will be the transmission of tax return data, if appropriate. Broken transmissions must be re-initiated from the beginning because there is no checkpoint capability at the IRS site. The EFS will terminate the communication session upon the receipt of the RECAP record.

4 Each transmitter sending session will consist of no more than 500 tax returns (approximately 30 minutes line time). If more returns are available for transmission, they must be sent in subsequent transmissions.

5 If a filer is filing fewer than 500 returns on a given day, all returns must be included in one transmission.

.02 Refer to Attachment XI for a description of the commmunications dialogue between the Service communications processor (Series/1) and the transmitter.

SEC. 11 Direct Deposit

.01 General Information

1 Taxpayers who file electronically and meet certain eligibilty requirements can elect to have their refunds directly deposited into their checking and savings accounts in financial institutions.

2 A taxpayer who elects Direct Deposit will not receive a refund check. Instead, the refund will be transferred directly to the designated financial institution for crediting to the taxpayer's account. This transfer will be effected by the Financial Management Service (FMS). The advantages of Direct Deposit to the taxpayer are that the refund amount is received more quickly and conveniently, the risk of loss is minimized and the funds are immediately available upon receipt.

3 Enrollment in Direct Deposit is voluntary. A taxpayer who elects to have part of the overpayment applied to next year's estimated tax credits can elect to have the balance of the overpayment directly deposited. However, an overpayment cannot be split between a Direct Deposit and a refund check.

4 Enrollment in Direct Deposit for income tax refunds is not a permanent election by the taxpayer. A new enrollment is required each year.

.02 Eligibility requirements for Direct Deposit are as follows:

1 The return must be filed electronically by a participating electronic filer.

2 The return must be for tax year 1987.

3 The taxpayer must show the electronic filer a proof of account issued by the financial institution designated by the taxpayer to receive the Direct Deposit. An acceptable proof of account is a check, a copy of Form 1099-INT, or a form, report or statement generated by the financial institution which contains the following information preprinted on the document. (See Attachment V.)

(a) Account Title (Name of the account on the records of the financial institution)

(b) Account Number

(c) Name of the Financial Institution (FI)

(d) Routing Transit Number (RTN) of the Financial Institution

4 The account designated to receive the Direct Deposit must be the taxpayer's, unless the filing status on the return is married filing joint or married filing separately. If the filing status on the return is married filing joint, the account can be that of either spouse or of both spouses. If the filing status on the return is married filing separately, the account can be the taxpayer's or a joint account with the spouse. The account cannot include the name of any other person.

5 The account must be a checking, share draft, savings or other consumer asset account held by a financial institution and established primarily for personal, family or household purposes. (A credit card account is excluded.)

NOTE: A check or share draft that is "payable through" another financial instituion is not eligible as a proof of account since it contains the RTN of the "payable through" financial institution rather than the financial institution where the account is located. The taxpayer must produce another document from the financial institution, such as an account statement, which contains the RTN of the receiving financial institution. (See Attachment VI.)

6 The financial institution must be a State or National bank, savings and loan association, mutual savings bank or credit union. "State" includes any State, territory or possession of the United States, the District of Columbia, the Commonwealth of Puerto Rico, or any political sub-division of the above.

7 Taxpayers do not need to obtain advance approval of their financial institutions to have their refunds directly deposited.

8 The taxpayer may designate a financial institution to receive the Direct Deposit, even when the financial institution prepared or transmitted the electronic return. The financial institution, however, cannot make a refund anticipation loan with respect to the Direct Deposit election. (See Section 11.08, subparagraph 6.)

9 If electronic filers accept any Direct Deposit enrollments, they must accept all Direct Deposit elections to any financial institution designated by taxpayers.

.03 The electronic filer must enter the Direct Deposit data on Form 8453, Taxpayer Declaration (see Attachment VII).

1 This includes the information described in paragraph 3 of Sec. 11.02, plus the following additional information obtained from the taxpayer:

(a) Type of Account—Savings or Checking.

(b) Ownership of Designated Account—Self, Husband, Wife, or Husband and Wife.

2 The electronic filer must complete all other required entries on Form 8453 and obtain the signature(s) of the taxpayer(s).

.04 Electronic Filer Processing of Direct Deposit Requests

1 Electronic filers will not charge a separate fee for Direct Deposit.

2 Electronic filers must include the following Direct Deposit data on the electronic return.

(a) Routing Transit Number—must be nine numerics.

(1) If less than nine digits, the account is ineligible for Direct Deposit.

(2) If Source Code is "2" for a check or share draft, the RTN is the first 9 digits printed on the bottom left of the check (see Attachment V).

(b) Account Number—maximum 17 positions.

(1) If less than 17 positions, enter the account number left-justified with trailing blanks.

IMPORTANT: Include hyphens and omit spaces and other special characters.

(2) If the Source Code is "2" for a check or sharedraft, the account number field on the source document follows the RTN. In some cases, this field may contain additional data in front of or behind the actual account number, such as the check serial number. If the check serial number is not clearly discernible, electronic filers should treat the entire field following the RTN, including hyphens, as the account number for purposes of Direct Deposit of income tax refunds. (See Attachment VIII.) Using this field, the receiving financial institutions will identify the actual account numbers and properly credit the refund amount. (If the combined field exceeds seventeen digits, the account is ineligible for Direct Deposit.)

NOTE: If a cancelled check is used as a proof of account, do not include the money amount field appearing in the right bottom margin of the cancelled check. See Attachment V.

(c) Source Code—one numeral with a value of 2 (Check) or 3 (Form 1099-INT or Other).

(d) Account Type—one alpha character with value of "S" for a savings account or "C" for a checking account.

(e) Ownership (of Designated Account) Indicator—one numeric position with the value of "0" for Self, "1" for Husband, "2" for Wife or "3" for Husband and Wife.

(1) If Ownership Indicator is "0", Filing Status (SEQ 130 of the return record) must be "1", "3", "4" or "5".

(2) If Ownership Indicator is "1" or "2", Filing Status (SEQ 130 of the return record) must be "2".

(3) If Ownership Indicator is "3", Filing Status (SEQ 130 of the return record) must be "2" or "3".

3 The data specified in Sec. 11.04 is required to be key entered from source documents twice to enable the electronic filer to detect and correct transcription errors. Such errors could delay the Direct Deposit, cause it to be handled incorrectly or cancel it altogether. Accordingly, filer software must compare the two independent key entries, and if they are not identical, generate an error message to initiate corrective action before the returns are transmitted to the Service.

4 In addition to the key verification described in paragraph 3, the electronic filer must validate the Direct Deposit data on the electronic return as follows:

(a) The electronic filer must validate the routing transit number, using the formula shown in Attachment IX.

(b) The electronic filer must ensure the consistency of the routing transit number and the account number entries with the comparable data on the Form 8453.

5 The electronic filer must transmit the electronic return to the IRS.

6 Taxpayers should be cautioned that once an electronic return has been released to the Service, the Direct Deposit election cannot be rescinded nor can the RTN or account number be changed.

.05 Processing of Direct Deposits by IRS and FMS

1 IRS will verify the direct deposit information contained on the electronic returns by:

(a) matching the entries in the five Direct Deposit fields of the Return and Summary records, and

(b) identifying Source Code/RTN inconsistencies or Account Number duplications.

2 If there is *any* inconsistency, the return will be rejected. The electronic filer will be advised of the error on the Acknowledgement File.

3 The IRS may also sometimes find it necessary to supersede the Direct Deposit election and issue checks which will be mailed to the address on the return. This would be due to conditions arising during processing, such as the need for special processing by IRS. When such a condition occurs, the IRS will normally issue an explanatory notice to the taxpayer.

4 IRS will send a Direct Deposit refund tape to FMS weekly for transmission to the designated financial institutions. The refunds will be transmitted via the Automated Clearing House (ACH) system to all financial institutions which accept electronic fund transfers. Note: Refer any questions about FMS' processing of Direct Deposits to Jim Knox at 202-287-0467 (not a toll-free number).

.06 Processing of Direct Deposits by Financial Institutions

1 The financial institutions will credit refunds to payee accounts in accordance with the procedures developed by IRS and FMS specifically for the Direct Deposit of refunds.

2 If an account number on a Direct Deposit transaction does not match the financial institution's records, the financial institution will attempt to credit the refund based on other identifying information which accompanies the payment (i.e., name, address, SSN, etc.). If this is unsuccessful, the financial institution will return the Direct Deposit to FMS, which will in turn notify the IRS. IRS will then authorize FMS to mail a refund check to the taxpayer.

.07 Non-Receipt of Direct Deposits

1 The IRS will not issue a written notice to taxpayers confirming Direct Deposits. To check the status of their refunds, taxpayers in all district areas should call the toll-free IRS Tele-Tax number 1-800-554-4477. EXCEPTION: Taxpayers in the Sacramento district who reside in the counties of Amador, Calaveras, Contra Costa, Marin and San Joaquin should call the toll-free Tele-Tax number 1-800-428-4032 instead. When calling, they should have available the primary Social Security Number (the first SSN listed, if a joint return), the Filing Status as shown on the return and the exact amount of the expected refund excluding any amount designated to be applied to 1987 estimated tax. The taxpayers should allow one week after the Tele-Tax refund issued date for their refund to be credited in their accounts.

> NOTE: At certain times the Tele-Tax system may not be available due to internal update processing. When this occurs, the taxpayer should call the following day.

2 When taxpayers call the Tele-Tax number and learn that their refund was *not* issued, they should call the electronic filer. The electronic filer, in turn, should verify that the IRS has acknowledged that the tax return has been accepted.

3 If from the Tele-Tax number, taxpayers learn that the Direct Deposit was issued but their account is not credited within a week from the date issued, they should contact the IRS to initiate trace actions. Trace actions for Direct Deposit will be routed to the receiving financial institutions by FMS for resolution. If, after four weeks, the financial institution has not contacted the taxpayer, or has failed to satisfactorily resolve the problem, the taxpayer should initiate a follow-up trace action with IRS.

4 If a taxpayer's account has not been credited with the refund four or more weeks after the electronic filer has received an acknowledgement from the IRS that the electronic return was accepted, and the taxpayer has not received a notice indicating that the refund will be issued by check, the electronic filer should advise the taxpayer to contact their local IRS district office for assistance.

5 Neither IRS nor FMS is responsible for the misapplication of a Direct Deposit which is caused by error or negligence on the part of the taxpayer, electronic filer or financial institution, or any of their agents.

.08 Refund Anticipation Loans

1 An electronic filer may assist a client in applying for a refund anticipation loan. This is a loan made by the financial institution designated to receive Direct Deposit of the anticipated refund. The loan would normally be repaid through an authorization to the financial institution to debit the account when the refund is credited. Financial institutions authorized to receive Direct Deposits are described in Sec 11.02.

2 An electronic filer may charge a fee to assist a client in applying for a refund anticipation loan, but such fee must be identical for all affected clients and must not be related to the amount of the refund or loan. The electronic filer may only share in the flat fees imposed by the lending financial institution to provide the loan and cannot share in any fees imposed by the financial institution based on the amount of the loan.

3 An electronic filer can disclose tax information to the lending financial institution in connection with an application for a refund anticipation loan only with the client's written consent as specified in Section 301.7216-3(b) of the Income Tax Regulations.

4 A Direct Deposit refund will usually be made within approximately three weeks of the date the electronic return is accepted. However, the Treasury Department will not guarantee that a refund will be issued by a specific date or for the requested amount. Further, sometimes a refund check will be issued to the taxpayer at his or her home address in lieu of a Direct Deposit. The electronic filer or the lending financial institution will not be notified if the Direct Deposit refund is delayed or cancelled, or if the amount is changed. The Treasury Department will not be liable for any loss incurred by the taxpayer, the electronic filer or the financial institution with respect to a refund anticipation loan. The absence of any guarantees with respect to the date the refund will be issued or the amount of such refund must be included on the refund anticipation loan application form. Further, electronic filers must advise taxpayers that if Direct Deposits are not timely, they may be liable for additional interest on the refund anticipation loan.

5 The IRS will not accept inquiries from financial institutions with respect to the timing or amount of a Direct Deposit. Also, prior to the filing of electronic returns, the IRS will not accept inquiries from taxpayers or electronic filers concerned with refund anticipation loans, e.g., whether the prospective refund would be subject to offset or delay, whether the taxpayer identification number is consistent with IRS records, etc. Inquiries subsequent to the filing of an electronic return must be in accordance with Section 6.

6 An electronic filer that is also the return preparer must not be affiliated (as defined in Section 1504(a) of the Internal Revenue Code) with the financial institution making the refund anticipation loan.

7 Actions taken by an electronic filer not consistent with this Revenue Procedure may result in the imposition of the penalties prescribed in Section 6695(f) of the Internal Revenue Code and/or may also result in suspension from electronic filing. Actions taken in violation of these provisions by a lending financial institution could result in the Service ceasing to honor requests from taxpayers to directly deposit refunds in those institutions.

SEC. 12 Monitoring

.01 The following conditions can lead to suspension:

1 Deterioration in the format of individual transmissions.

2 Cumulative error rate is not acceptable.

3 Violation of advertising standards.

4 Unethical practices in return preparation.

.02 The Service will monitor the quality of filers' transmissions throughout the filing season. The Service will also monitor electronic returns and tabulate rejects, errors and other defects. If the quality deteriorates, the electronic filer will receive a warning from the Service, or in extreme cases, a letter suspending the electronic filer from electronic filing.

.03 The Service will monitor advertising and return preparation practices of electronic filers for consistency with Service requirements. If the situation warrants, a warning letter will be issued prescribing specific corrective action for cited deviations. If the deviation is not corrected, a letter of suspension will be issued to the filer by the Service. In extreme cases, the filer will be suspended immediately from electronic filing without a warning letter. The suspension will remain in effect until the Service has determined that the deviations have been corrected.

.04 When suspended, the electronic filer will be counseled concerning the requirements for re-acceptance in the electronic filing program.

SEC. 13 Administrative Review Process

.01 The electronic filer has the right of administrative review of the suspension decision.

.02 Requests for administrative review of suspension decisions should be directed to the Office of the Director of Practice (PM:HR:DP), 1111 Constitution Ave. N.W., Washington, D.C. 20224.

SEC. 14 Effect on Other Documents

Rev. Proc. 87-16 dated April 27, 1987 and Rev. Proc. 87-52 dated October 5, 1987 are superseded.

Appendix A – Electronic Return File Specifications

SECTION 1 Summary

.01 After the transmitter has been authenticated, an acknowledgement transmission will commence, if appropriate. The sequence of acknowledgement records is as follows:

1 The original Trans record.

2 An Ack record for each recognizable return received.

3 The original Recap record plus counts for accepted and rejected returns.

.02 If the entire transmission is rejected, the acknowledgement transmission will contain the following:

1 the original Trans record, and

2 one Ack record containing the Reject Code (Field 14e) significant.

3 the original Recap record with Fields (9) through (12) zero-filled.

.03 After the acknowlegdement transmission, a return record transmission will commence. The sequence of record transmissions is as follows:

1 Trans record (this record identifies the transmitter).

2 Tax Return records (including the return (RET), and all related schedule (SCH), form (FRM), statement (STM) and summary (SUM) records).

3 Recap record.

(This sequence will be repeated for each batch of 500 returns transmitted in a subsequent session.)

.04 All returns on a transmission must be from the Cincinnati (A) or Ogden (B) designated processing areas (see Processing Site Designator, Element (8), in the Trans Record).

Sec. 2 General Description

.01 Byte Counts

1 EBCDIC transmissions must use the IBM Byte count convention. A four byte counter must precede each logical record. The byte counts contain the length of the record or block plus the length of the byte count.

2 ASCII transmissions must use the ANS Byte count convention. A four byte counter must precede each logical record in a block. The byte counts contain the length of the record plus the length of the byte count.

3 Record byte counts are provided for filers using the fixed format option. They may be found preceding the Record ID field in the record layout for each record. Filers using the variable format option must compute their own byte counts.

4 EBCDIC transmitters must compute the block byte count by adding the byte counts of the records in the blocks and then adding four to the total.

.02 The first record on a transmitted file (the TRANS record) contains information regarding the transmitter and file format. This record should be followed by the records comprising the tax returns being transmitted. The last record on a transmitted file (the RECAP record) will provide balancing counts of returns.

.03 A tax return will consist of a variable number of fixed-field records. The size and format of the logical record for each page of each form, schedule etc., are specified herein. In addition, a variable field/record format option is acceptable. See details under Variable Length Option. Maximum block size is limited to 512 bytes, excluding bi-synchronous control characters.

.04 (Reserved)

.05 Each logical record should contain all data fields pertaining to one printed page of an official form or schedule or to a line of a continuation statement. Therefore, the logical record contains an entire form or schedule; a logical part (i.e., a page) of a form or schedule; or, a logical part (i.e., a line) of a statement. The complete tax return must consist of all logical records pertaining to it in the following sequence: *Return, Schedules, Forms, Statements* and *Summary*. Schedules must be in alphabetical sequence and forms must be in numeric sequence. Forms W-2, W-G and W-2P records shall appear as the initial forms in the Form Record sequence. Return, Schedule, Form, and Statement Records may contain additional sequential Page Records if they consist of more than one printed page.

(Pages are only numbered within a form, schedule or statement, not across the return.) All records must appear in the proper sequence, with the proper control information and the counts of the schedules and forms must balance to the Summary Record or the return will be rejected.

.06 A page need not be generated, if there are no entries on the page record of a form or schedule.

.07 The first logical record for a tax return (i.e., the Return Record for page 1 of the tax form) will include the tax period, return type, the Declaration Control Number (containing the Electronic Filer Identification Number of the electronic filer who prepared the return), and the Return Sequence Number (RSN). The Return Sequence Number is a unique 16-digit field assigned by the transmitter to each return within a return transmission. The RSN includes the transmitter's Electronic Filer Identification Number (EFIN) and the date and sequence of the transmitted return and consists of the following fields:

1 Electronic Filer Identification Number (EFIN) of the transmitter (5 numerics)

2 EFIN suffix, the value of which is determined by the transmitting electronic filer (2 numerics)

3 Julian date of transmission (3 numerics)

4 Transmission sequence number for the given Julian Date (2 numerics)

5 Sequential number assigned to the return (4 numerics).

NOTE: Do not confuse the RSN and the DCN. The Declaration Control Number (DCN) included in the Return Record ID must contain the EFIN of the electronic filer who prepared the return, even if the Transmitter assigns the DCN as a service to the electronic return preparer.

.08 If the number of data items appearing on the same line exceeds the number that can be contained in the space provided on the printed form or schedule, the data must be provided on a separate continuation statement (STM) record. There is a maximum of 20 statement page records per return in total. If STM is used, no data should be entered in the base return.

1 The first line entry for the continued item on the base form or schedule record itself shall read "STMbnn ("nn" being the applicable statement number). All of the applicable entries (the "*" field and any related " + " fields) must then be on the statement record and cannot be split between the continued item record and the statement.

2 The first statement record will contain a literal description of the item continued (e.g., "Interest Income, Schedule B").

3 The second statement record for all continuations of tabular data should contain the column headings (e.g., "Name of Payer............ Amount...........") spaced with the headings as they would appear on the printed form they continue.

4 The third statement record will contain, left-justified, a series of two position counters giving the length and displacement from the left margin of each related field which will appear on the same line (e.g., if a 20 position description and a 12 position amount are to be positioned beginning in columns 15 and 40, the record would contain "20151240").

5 Each following statement record from "LN04" on will contain, left-justified, the related data fields in the same format as they appear in the base layout.

6 Statements can *only* be used by the electronic filer when the open-ended item *cannot* be contained in the space provided on the printed form or schedule. See details under Statement Record Layout in Section 8 below.

.09 All money fields are 12 characters (11 numerics followed by the sign character or 12 spaces). Money fields containing no significant data *must* be filled with spaces. The significant numeric characters must be right-justified and zero filled. Dollar signs, decimal points, or other non-numeric characters are not permitted. The right-most position of any negative money field must contain the negative sign; for positive fields this position is always blank. Money fields must be all whole dollars (no cents).

> Note: Fields which can only contain loss amounts, such as Schedule D, Total Short Term Column (f) Losses, must be transmitted as positive fields. Fields which can contain either gain (income) or loss amounts, such as Schedule D, Line 17, Net Long Term Gain/Loss must be transmitted with the applicable sign character, i. e., blank for positive amounts and minus for negative amounts.

.10 All percentage fields must be five positions, left-justified and zero filled. Do not enter the decimal point on the record. The decimal point will be assumed to be between the left-most and the second left-most positions. If percentage is less than 100%, precede the figure with a zero. For example, 25.32% would be entered as "02532" and 105% would be entered as "10500".

> Exception: Form 6252, Line 15, Gross Profit Ratio requires five positions following the decimal point. When this field is significant, do not enter the leading zero. The decimal point will be assumed to precede the left-most position. For example, if Gross Profit Ratio equals 65.987 percent, enter as "65987".

.11 A summary record will be the final record for each tax return. This record will contain electronic filer identification data and counts of the Schedules, Forms and Statements included in the return and indicators for paper documents retained by the electronic filer for subsequent transmission to the IRS.

.12 Except where designated, do not enter blanks or spaces between data elements.

.13 The file should be unlabeled (no standard header or trailer records).

.14 Each file must contain only complete returns.

.15 All alphabetic data must be in upper case only.

.16 For fixed format, blank fill all nonsignificant fields unless otherwise specified in the Electronic Return Record Layouts.

Sec. 3 TRANS Record

.01 The first record on each file is the TRANS record which will contain the following (for this purpose, Transmitter is the firm handling the data communication):

Sec. 4 Variable Length Option

.01 The variable format will be indicated by a "V" in the Record Type field of the initial Transmitter (TRANS) Record for a file. In this format the data field is preceded by the applicable field identification number shown in specific record layouts. The field identification number is enclosed with field delimiters ([ ]). These characters will also enclose the control information (i.e. Record I.D. field) which begins each return, schedule or form record. The beginning of record control information remains in the same fixed format shown; the individual data fields need only contain the significant data (i.e. no leading zeros or trailing spaces). The Summary and Statement records, which are not keyed to field numbers, must be full length expanded records but must still be enclosed in field delimiters.

.02 Each variable record (including the Statement and Summary Records) will end with a Record Terminus Character (#). There must not be any extraneous characters between terminus characters and the byte count preceding the next logical record.

> *IMPORTANT*: THE FOLLOWING THREE CHARACTERS "[", "]", and "#" ARE RESERVED AS DELIMITERS AND MAY *NOT* APPEAR AS DATA CHARACTERS. The basic record would follow the format below.

[RECORD ID FIELD] [1st field number] DATA
[Next field number] DATA ... #

.03 A list of special symbols and their hexidecimal and octal conversion characters for ASCII and EBCDIC are contained in Attachment XII.

Sec. 5 Tax Return Record

.01 The Page 01 record for each tax return (Form 1040) starts with the following 10 fields. Page 2 of each Form 1040 will have a new page record with the Page Number incremented to "02". These records will each begin with Fields 1-8 below.

Sec. 6 Schedule Record

.01 The second record or series of records is the Schedule Record. Each page of a schedule will have a new Schedule Record with the Page Number incremented. This record should appear in alphabetic order by Schedule type.

Sec. 7 Form Record

.01 The third series of records after Returns and Schedules are the Form records. They should appear in numeric order by form number. Each page of a form will have a new Form Record with the Page Number incremented.

Field#	*Identification*	*Length*	*Description*
	Byte Count	4	"0170"
(1)	Record I.D.	5	Value "TRANS"
(2)	Transmitter Name	35	Alphanumeric
(3)	EIN of Transmitter	9	Numeric
(4)	Address	35	Alphanumeric
(5)	City, State, Zip Code	35	Alphanumeric
(6)	Area Code, Telephone Number	10	Numeric
(7)	Type Transmitter	16	Value = "Preparer's Agent" or "Preparer"
(8)	Processing Site	1	"A" = Cincinnati, "B" = Ogden
(9)	Transmission Date	6	MMDDYY
(10)	Electronic Transmitter Identification Number	7	Numeric
(11)	Julian Date of Transmission	3	Numeric
(12)	Transmission Sequence Number for Julian Date of Transmission	2	Numeric
(13)	Acknowledgement Transmission Format	1	"A" = ASCII, "E" = EBCDIC
(14)	Record Type	1	F = fixed, V = variable length option

Field#	*Identification*	*Length*	*Description*
	Byte Count, Page 1	4	"0066" plus length of data fields
	Byte Count, Page 2	4	"0036" plus length of data fields
(1)	Record ID	4	Value "RETb"
(2)	Return Type	6	Value "1040bb"
(3)	Source Return Indicator	2	"0b" = F1040, "1b" = F1040A, "2b" = F1040EZ
(4)	Page Number	5	Value "PG0lb", format PGnnb, "nn" = 01 to 02
(5)	Primary Social Security Number (P-SSN)	9	9 Numerics
(6)	Filler	1	Blank
(7)	Tax Period	4	Value "8712", YYMM
(8)	Filler	1	Blank
***Begin data fields here for Page 02 ***			
(9)	Return Sequence Number	16	Numeric (See paragraph .07 under General Description)
(10)	Declaration Control Number	14	Assigned by electronic filer to taxpayer declaration and related paper documents
Begin data fields here for Page 01			
(11)	Data Fields	Various	Page data fields

Field#	*Identification*	*Length*	*Description*
	Byte Counts, Page 1 and Page 2	4	"0030" plus length of data fields
(1)	Record ID	4	Value "SCHb"
(2)	Schedule Type	6	Alphanumeric (left-justified) Values "Abbbbb", "Bbbbbb", etc.
(3)	Schedule Sequence Number	2	Value 1b, 2b or 3b
(4)	Page Number	5	Value "PGnnb" nn = 01 to 02
(5)	Social Security Number	9	Primary SSN
(6)	Data Fields	Various	Page data fields

Sec. 8 Statement Record

.01 The statement record is the fourth series of records after Returns, Schedules and Forms. Statement records are used to continue a field or related series of fields which *appear on the same print line*. Each statement is given a sequential number from OO to 99. References to statements on the tax return must be in ascending numerical sequence and must be referenced in the same sequence as the transmission sequence of the forms. Note: Although statement reference numbers must be in ascending sequence, they do not have to be in consecutive numerical sequence. The first data field of the line item(s) being continued will contain "STMbnn" with "nn" being the sequential statement number. Each statement will consist of a series of records with LINE NUMBERS of 01 up to 50 for each sequential PAGE NUMBER. There are maximums of 2 statement pages per statement and 20 statement pages per return. A statement can only be referred to once in a tax return

.02 After the control information there will be 80 characters of data for each line. The first line record (LNO1) for each page of a statement will contain only the title of the item(s) being continued. The second line of each page (LN02) will contain the column titles for tabular data. For continuous non-tabular data (e.g., Type of Other Method, Schedule C) this line will be blank.

.03 The third line record (LN03) contains up to eight pairs of two digit counters giving the field length and beginning displacement from the left margin for printing of each related field occurring in the same print line. For continuous non-tabular data (e.g., Type of Other Method, Schedule C) this line will be blank.

.04 The tabular column titles will be spaced in the same format as would be printed on a blank continuation page. Related contiguous fields which would have appeared as a single print line on the basic form or schedule shall also appear contiguously on the same Statement line record, left justified, beginning with the fourth line record ("LN04") on. The first data field for a table or a group of related line entries (e.g., Interest or Dividends on Schedule B) must contain the "STMbnn" for the entire table (i.e., part of the table cannot appear on the form and part in a statement).

.05 Only fields marked with an asterisk (*) in the record layout may contain "STMbnn". Fields marked with a plus sign (+) identify the related fields which must be included on the statement record with the asterisked field. Fields marked with an "" sign" in the record layout *must* contain "STMbnn" on the record and the data field(s) *must* appear on a statement record.

When the related fields cannot be contained within the 80 positions allowed in the statement record, a second statement record with a different statement number is required. This condition is identified with a plus sign and an asterisk (+*) preceding the first field to be included in the second statement record. (See to Sections 10 and 27 in the Record Layouts.)

.06 Refer to Attachment XIII for examples of statement records.

Sec. 9 Summary Record

.01 The final record for each tax return is the summary record. (A "1" in the paper document indicator field shows that the paper document specified is a part of the return, and has been attached to the Taxpayer Declaration Form 8453.) The format is as follows:

Sec. 10 RECAP Record

.01 The final record on each file is the RECAP record. This record will contain a count of all returns in the file by type, and by a grand total. The format is as follows:

Sec. 11 Format of the Acknowledgement File

.01 The acknowledgement will be a transmission of a file consisting of the TRANS record submitted by the transmitter, an acknowledgement ("ACK") record for each recognizable return transmitted and the original "RECAP" record information submitted, plus counts for accepted, rejected and duplicate records. For each transmission file sent during a transmission session, a separate ACK file will be transmitted back to the sender within two workdays.

Field#	Identification	Length	Description
	Byte Counts, Page 1 and Page 2	4	"0030" plus length of data fields
(1)	Record ID	4	Value "FRMb"
(2)	Form Number	6	Alphanumeric (left-justified)
(3)	Form Sequence Number	2	Value 01 thru 99
(4)	Page Number	5	"PGnnb" nn = 01 to 02
(5)	Social Security Number	9	Primary SSN
(6)	Data Fields	Various	Page data fields

Field#	Identification	Length	Description
	Byte Count	4	"0030" plus length of data fields per LN (line)
(1)	Record ID	4	Value "STMb"
(2)	Statement Number	3	nnb, nn = 00-99
(3)	Page Number	5	Value "PGnnb" nn = 01 to 02
(4)	Line Number	5	LNnnb, nn = 01-50
(5)	SSN	9	Primary SSN
(6)	Statement Data	80	Statement Title if "LN01"; column Titles or blank if "LN02"; up to 8 pairs of counters giving field lengths and displacements of following data elements or blank if "LN03"; otherwise, left-justified field(s) from record being continued.

NOTE: Refer to Sec. 2, paragraph .08 for restrictions on the use of statement records. Data cannot be split between the return, schedule, or form record and a statement record. If more entries are required than are provided for in the Return Specifications and Record Layouts, enter "STMbnn" in the field or the first of a series of fields on the return, schedule or form record and put the specific data entries on the statement record.

.02 Further, if an ACK record contains an "R" in the Acceptance Code field, the return has been rejected due to a fatal error involving the return format, internal consistency, or data errors in a key field, and must also be corrected and resubmitted to the IRS to be considered as a filed return.

.03 If an ACK record contains a "D" in the Acceptance code field, the return has been identified as a duplicate record, i.e., a return record has previously been transmitted and accepted for that Primary Social Security Number.

.04 Any tax return with an "A" in the Acceptance Code field has been accepted as a filed tax return and will be processed from that point in the same manner as a return originally submitted on a paper document. This does not imply that the return will pass all IRS service center validity checks or post to the IRS Master File without delays.

.05 Any return with a "D" in the Duplicate EFT field has been rejected because it contained an Account Number for direct deposit which has already been recorded as contained in a previously accepted return record.

Exception: A duplication of the Account Number is acceptable only when the Filing Status on the return is married filing separately.

.06 The acknowledgement file can be a separate transmission or can precede a return file transmission.

.07 The first record on the acknowledgement file will be the same TRANS record as the first record of the tax return file being acknowledged. (see TRANS Record format above). An ACK record will be generated for each recognizable tax return in the transmission.

Sec. 12 Acknowledgement Record

.01 The format for the ACK record follows.

.03 Error Counter Explanation

1 Internal Inconsistency-The total number of records, forms, schedules or statements for the return, do not balance to totals in Summary Record.

2 Control Data Error-Erroneous data or sequence error(s) present in the control information at the beginning of each logical record.

3 Key Field Data Error–Data is present in a key field that is not within the valid range specified, significant data is present in "NO ENTRY" fields, or the bottom line entries for schedules and forms do not agree with the carry-forward entries on the return, schedule or form.

.04 Reject Code Explanation

1 Up to 10 three position Reject Codes will be furnished to the electronic filer on the Acknowledgement File. Filers should use these codes to determine the source of the error causing the return (or transmission) to reject. If more than 10 reject conditions are identified, the first 9 Reject Codes will be listed followed by "999". When this occurs, the filer cancontact the Electronic Filing Unit at the applicable service center for information about the additional reject conditions.

2 The First Error Field and Data Element Number provided in the Acknowledgement record relates to the first Reject Code listed.

3 The Reject Codes and brief explanations of the conditions that cause the codes to be assigned are listed in Attachment XIV. Filers should use this information to resolve reject conditions. When a condition cannot be resolved with the information provided, the filer should contact the Electronic Filing Unit at the applicable service center for assistance.

Field#	*Identification*	*Length*	*Description*
	Byte Count	4	"0228"
(1)	Record ID	4	Value "SUMb"
(2)	Non-Paid Preparer	13	Values "TC", "TCE", "TC-X", "TCE-X", "VITA", "VITA-T","SELF-HELP", "IRS-PREPARED", "IRS-REVIEWED", "OUTREACH" (left-justified) or blanks
(3)	Social Security Number	9	Taxpayer's SSN (Primary taxpayer's SSN if married filing a joint return)
(4)	Name of Paid Preparer	35	Alphanumeric
(5)	Preparer's SSN	9	Numeric
(6)	Preparer Self-Employment	1	Alphanumeric ("X" if self-Indicator employed), otherwise blank
(7)	Preparer Firm EIN	9	Numeric
(8)	Preparer Firm Name	35	Alphanumeric
(9)	Firm's City	20	Alphanumeric
(10)	Firm's State	2	Alpha
(11)	Firm's Zip	9	Numeric
(12)	Number of Logical Records in Tax Return (including Summary)	4	Numeric
(13)	Pages of Schedules C	1	Numeric (0–6)
(14)	Pages of Schedules SE	1	Numeric (0–2)
(15)	Pages of Forms 2106	1	Numeric (0–2)
(16)	Pages of Forms 4562	1	Numeric (0–6)
(17)	Pages of Forms 6198	1	Numeric (0–3)
(18)	Pages of Forms 6252	1	Numeric (0–3)
(19)	Pages of Forms 8582	1	Numeric (0–1)
(20)	Pages of Forms 8606	1	Numeric (0–2)
(21)	Number of Forms W-2	2	Numeric (00–20)
(22)	Number of Forms W-2G	2	Numeric (00–30)
(23)	Number of Forms W-2P	2	Numeric (00–10)
(24)	Number of Schedule Records	2	(00–99) (Occurrences of "SCHb")
(25)	Number of Form Records	3	(000–999) (Occurrences of "FRMb")
(26)	Number of Statement Records	3	(000–999) (Occurrences of "STMb")
(27)	Paper Document Indicator 1	1	"1" = Form W-2, else "0"
(28)	Paper Document Indicator 2	1	"1" = Form 2120 (Multiple Support Agreement), else "0"
(29)	Paper Document Indicator 3	1	"1" = Form 8332 (Exemption for Non-Custodial Parent), else "0"
(30)	Paper Document Indicator 4	1	"1" = Physician's Certification of Blindness, else "0"
(31)	Paper Document Indicator 5	1	"1" = Physician's Certification of Disability (signed paper Sch. R), else "0"
(32)	Paper Document Indicator 6	1	"1" = W2-P, else "0"
(33)	Paper Document Indicator 7	1	"1" = W2-G, else "0"
(34)	Paper Document Indicator 8	1	"1" = Form 8283, Page 2, Appraisal Summary, else "0"
(35)	Paper Document Indicator 9	1	"1" = Other Document(s), else "0"
(36)	Routing Transit Number	9	Numeric
(37)	Account Number	17	Alphanumeric (including hyphens)
(38)	Source Code	1	Numeric (2 or 3)
(39)	Account Type	1	Value "S" or "C"
(40)	Ownership Indicator	1	Numeric (0–3)
(41)	Reserved	14	Blanks

Note: Fields (36) through (41) apply to Direct Deposit of Refunds. Refer to Section 11 of the Revenue Procedure for Electronic Filing,.

Sec. 13 Format of the Acknowledgement File RECAP Record

.01 After the ACK records, the final record of the file will be the RECAP record which is the final record of the tax return file being acknowledged with the addition of counts for accepted and rejected returns.

Sec. 14 Data Validation and Rejection Criteria

.01 The following data controls must be adhered to or the return will be rejected:

1 The data records of the transmission must be in the following sequence: TRANS record, return records (1–500) and RECAP record.

2 The format of the TRANS and the RECAP record must correspond exactly to the record layouts specified above. Program accumulators will be maintained which correspond to the counters shown in the RECAP record. The entire transmission will be rejected when any of the following conditions exist:

(a) The Total EFT (Field 4 in the RECAP Record) mismatches;

(b) The Total Return Count (Field 5 in the RECAP Record) mismatches;

(c) The Count of Overpaid Returns (Field 8 in the RECAP Record) mismatches;

(d) There is no TRANS record.

3 The data records of the tax return must be in the following sequence: Return, Schedule, Form, Statement and Summary.

4 Accumulators will be maintained when processing each set of records for a tax return which corresponds to the counters in the SUMMARY record. If they disagree, the return will be rejected.

5 Page (PGnn) records must be consecutive and sequential.

Note: Schedule E, Page 2 (SCHbEbbbbbnbPG02, etc.) may be present without Schedule E, Page 1 (SCHbEbbbbbnbPG01, etc.)
Page 2 of Schedule C, Form 2106, Form 4562, Form 8283 or Form 8598 need not be transmitted if there are no entries for that page.

6 Schedule records must be in ascending alpha sequence.

7 Any W-2 records must be in the following sequence: Form W-2, Form W-2G and Form W-2P. These records must follow the return and any schedule records and precede any other Form records.

8 Form records must be in ascending numeric sequence.

9 The Schedule Sequence Number (Field 3 of the Schedule Record) and Form Sequence Number (Field 3 of the Form Record) must be significant and in ascending numerical sequence if more than one schedule or form type is present. The sequence number must not be greater than that permitted for the particular form or schedule.

Note: With multiple schedules or forms, the Page Number must be sequential within the Schedule Sequence Number of a schedule or the Form Sequence Number of the form.

10 Statement records do *not* have to be consecutive but must be in ascending sequence. Each statement number reference occuring in a data field ("STMbNN") must have a corresponding statement record. Each statement record may be referenced only once. There may be no more than 20 statement page records with any return. For each statement record, LN01, LN02, LN03 and LN04 must be present and all line numbers must be in ascending numeric sequence. When completing a table or listing other items, such as, Schedule D, Short F1099-B Desc, or Schedule C, Other Expense Type, the items must be listed in ascending numerical sequence, i.e., Short F1099-B Desc 1, then Short F1099-B Desc 2, then Short F1099-B Desc 3, etc.

11 The Declaration Control Number in the Return record information must be in ascending numerical sequence. However, the DCNs within a transmission do not have to be consecutive.

12 The Return Sequence Number in the Return record information must be in ascending numerical sequence.

Field#	*Identification*	*Length*	*Description*
	Byte Count	4	"0119"
(1)	Record ID	5	Value "RECAP"
(2)	Reserved	6	Numeric
(3)	Reserved	6	Numeric
(4)	Total EFT	6	Numeric
(5)	Total Return Count	6	Numeric
(6)	Total Logical Return Records	6	Numeric
(7)	Reserved	12	Numeric
(8)	Count of Overpaid Returns	6	Numeric
(9)	Electronic Transmitter Identification Number	7	Numeric
(10)	Julian Date of Transmission	3	Numeric
(11)	Transmission Sequence Number for Julian Date	2	Numeric
(12)	Transmitter User Area	50	Filler (alphanumeric)

Field#	*Identification*	*Length*	*Description*
	Byte Count	4	"0129"
(1)	Record ID	4	Value "ACKb"
(2)	Return Type	6	Field (2) of the Tax Return Record
(3)	Primary Social Security Number	9	Numeric
(4)	Electronic Filer Identification Number (EFIN)	5	Numeric (see Sec. 2.07, General Description
(5)	Preparer's Use to Futher Identify Originating Office	2	Numeric (see Sec. 2.07, General Description
(6)	Julian Date of Transmission from Originating Office	3	Numeric (see Sec. 2.07, General Description
(7)	Transmission Sequence Number for Date Specified in (6)	2	Numeric (see Sec. 2.07, General Description
(8)	Sequential Number Assigned Return for Transmission Sequence in (7)	4	Numeric (see Sec. 2.07, General Description
(9)	Expected Refund	10	Refund Field from Applicable Return
(10)	Acceptance Code	1	Value "A" = Accepted, "R" = Rejected, "D" = Duplicate
(11)	Date Accepted	6	Date of Acceptance (MMDDYY)
(12)	Reserved	4	Numeric
(13)	Error Counters		
(a)	Internal Inconsistency	2	Numeric 00-99
(b)	Control Data Error	2	Numeric 00-99
(c)	Key Field Data Error	2	Numeric 00-99
(14)	First Error Field		
(a)	Record ID	12	First 12 positions of the Record ID
(b)	Filler	1	Blank
(c)	Data Element Number	4	Sequence Number of first field in error right-justified; Field 5 (Line Number) of Record ID for STMb.
(d)	Filler	1	Blank
(e)	Reject Codes	30	Numeric (maximum of 10 three digit codes)
(15)	Duplicate EFT	1	"D" or Blank
(16)	Return DCN	14	Numeric

However, the RSNs within a transmission do not have to be consecutive.

13 All fields must contain the type of data specified under the columnar heading "Field Description" in the record layouts.

14 All alpha characters must be in upper case and all alphanumeric fields must be left-justified unless otherwise specified.

15 Significant money fields must be right-justified and zero filled. Significant percentage fields must be left-justified and zero filled. All other significant numeric fields must be right-justified and zero filled.

16 Byte counts must precede the Record ID for each page record and the count must equal the total number of characters contained in the page record.

17 The fields on a statement Line (LN) record must be in the same format and sequence as they appear in the record layouts and only one group of related fields can be entered per statement Line (LN) record.

18 The Primary Social Security Number (P-SSN) must be numeric and be consistent in the Record IDs of all data records for a tax return.

19 The tax period must be "8712".

20 The format and content of the record identification information (Record ID) which begins each type of record must be exactly as presented in the input specifications.

21 Married filing joint and married filing separate returns must contain both a primary and a secondary SSN or the literal "NRA" instead of the secondary SSN indicating a non-resident alien spouse with no income or SSN.

22 There *must be no* significant data present for the following fields from the Form 1040 record:

Seq #	Title	Line #
020	Primary Date of Death	
040	Secondary Date of Death	
470	Other Gain/Loss	15
520	Farm Income	18
855	Form 8615 Block	37
870	Form 4970 Block	38
880	Form 4972 Block	38
890	(Reserved)	38
910	Additional Taxes	38
990	Foreign Tax Credit	44
1003	Form 3800 Block	45
1005	Form 3468 Block	45
1007	Form 5884 Block	45
1009	Form 6478 Block	45
1011	Form 6765 Block	45
1013	Form 8586 Block	45
1015	General Business Credit	45
1020	Total Business & Other Credits	46
1060	Recapture Investment Credit	50
1070	Railroad Retirement Indicator	
1080	Social Security on Tips	51
1100	Tax on Retirement Plans	52
1190	Form 4868 Amount	57
1210	Credit for Special Fuels Tax	59
1220	Form 4469 Indicator	
1225	Form 4469 Amount	
1230	Regulated Investment Co	60
1240	Overpaid Windfall Indicator	
1245	Overpaid Windfall Amount	
1290	Amount Owed	65
1300	Form 2210 Indicator	
1310	ES Penalty Amount	
1320	Remittance	
1380	Refund Indicator	

23 Only three Schedules C may be included on the tax return.

24 Only one Schedule E with no more than three rental properties may be included on the tax return.

25 Only one Schedule SE for each taxpayer is permitted on the tax return (maximum two on a joint return).

26 Only one Form 2119, Sale or Exchange of Residence, may be included on the tax return.

27 Only one Form 2106 for each taxpayer is allowed on the tax return (maximum two on a joint return).

28 Only three Forms 4562 may be included on the tax return.

29 Only three Forms 6198 may be included on the tax return.

30 Only three Forms 6252 may be included on the tax return.

31 Only one Form 8582 may be included on the tax return.

32 Only one Form 8606 for each taxpayer is allowed on the tax return (maximum two on a joint return).

33 On a married filing jointly return, the Social Security Number of the taxpayer liable for self-employment tax must appear on the Schedule SE record. If both spouses are liable for self-employment tax, the Schedule SE for the primary taxpayer must precede the Schedule SE for the spouse.

34 On a married filing jointly return, the Social Security Number of the taxpayer claiming the Employee Business Expense Deduction must appear on the Form 2106 record.

35 On a married filing jointly return, the social Security Number of the taxpayer reporting his/her IRA information must appear on the Form 8606 record.

36 All "totals" fields must have a significant entry when there are amounts leading to the total. Similarly, any "totals" field which has a significant entry must have at least one significant entry leading to that amount. Otherwise, the processing of the return will be delayed to resolve the discrepancy.

37 There may be no significant entry for the fields of the Schedules and Forms specified below.

38 If any of the following fields are blank, the return will be rejected.

39 The following fields must be equal (comparison of bottom line of schedule or form with return carry-forward line) or vice versa:

40 If Filing Status (SEQ-130) equals "5", Year Spouse Died (SEQ-155) must equal "85" or "86".

41 If Withholding (SEQ-1160) Form 1040 is greater than zero, then Form W-2 (SEQ-050) Withholding, Form W-2G (SEQ-050) Withholding, Form W-2P (SEQ-070) Withholding, or Form 1099/1099R Indicator (SEQ-1140) must be present.

42 Refund (SEQ-1270) plus Applied to ES (SEQ-1280) must equal Overpaid (SEQ-1260).

Field#	*Identification*	*Length*	*Description*
	Byte Count	4	"0081"
(1)	Record ID	5	Value "RECAP"
(2)	Reserved	6	Numeric
(3)	Reserved	6	Numeric
(4)	Total EFT	6	Numeric
(5)	Total Return Count	6	Numeric
(6)	Total Logical Return Records	6	Numeric
(7)	Reserved	12	Numeric
(8)	Count of Overpaid Returns	6	Numeric
(9)	Total Returns Accepted	6	Numeric
(10)	Total Duplicate Returns	6	Numeric
(11)	Total Returns Rejected	6	Numeric
(12)	Total Duplicate EFT	6	Numeric

NOTE: Fields 1-8 are identical to those in the RECAP record originally transmitted. Fields 9 through 12 are the total returns accepted, rejected, duplicates and EFT duplicates (counts of "A", "R" and "D" codes from ACK record Field 10, Acceptance Code and "D" from ACK record Field 15, Duplicate EFT).

43 "Child Care", "Medical", "Casualty", "Theft" may not be present in Other Expenses Type (SEQ-420) or Misc Expense Not Subject to 2% Limit Type (SEQ-475) of Schedule A.

44 Gain Taxable This Year (SEQ-280) Form 2119, Line 14, must equal either Residence Short Gain (SEQ-790) Schedule D, Line 3(g), or Residence Long Term Gain (SEQ-1720) Schedule D, Line 10(g) or Form 6252, Computation of Insallment Sale Income, must be present.

45 The sum of Installment Sale Gain (SEQ-800) Schedule D, Line 4(g), and Installment Sales Long Term Gain (SEQ-1730) Schedule D, Line 11(g), must equal the sum of Line 21 Minus 22 (SEQ-290) Form 6252, Line 23, and Line 29 Minus Line 30 (SEQ-460) Form 6252, Line 31.

46 If Total Alimony Paid (SEQ-697) Form 1040, Line 28, is present, then Recip Soc Sec # (SEQ-693) Form 1040, must be present or vice versa. (If alimony has been paid to more than one former spouse, enter "STMbnn" in Recipient Last Name (SEQ-690), enter the SSN of one of the former spouses in Recip Soc Sec # (SEQ-693) and enter the total amount of alimony paid to all former spouses in Total Alimony Paid (SEQ-697). List the Recipient Last Name (SEQ-690), Recip Soc Sec # (SEQ-693) and Alimony Amount (SEQ-695) for each former spouse on the related Statement record.

47 Employer ID Number (SEQ-060) Schedule C, Block D, cannot equal Primary SSN (SEQ-010) Form 1040, or Secondary SSN (SEQ-030) Form 1040.

48 There are other fields that that must have an entry when certain conditions exist. These include, but are not limited to, the following.

(a) On Schedule R, Taxable Disability (SEQ-150) must contain an entry when Retired/Disabled (SEQ-020) Line 2; Both Under 65, One Retired (SEQ-040) Line 4; Both Under 65, Both Retired (SEQ-050) Line 5; One Over 65, Other Retired (SEQ-060) Line 6; or Under 65, Did Not Live With Spouse (SEQ-090) Line 9 box is checked (X'd).

(b) On Form 2441, Spouses Income (SEQ-060) must contain an amount greater than zero when Filing Status (SEQ-130) Form 1040 equals "2".

(c) On Form 2441, if Qualified Expenses (SEQ-040) is greater than zero, then Earned Income (SEQ-050) must be greater than zero.

(d) On Form 2119, if Exclusion Amount (SEQ-230) is greater than zero, then

(1) Questions 3a through 3e (SEQ-060 or 070) and (SEQ-100 or 110) and (SEQ-120 or 130,) must be checked as applicable.

(2) Then, if Filing Status (SEQ-130) is "2" or "3", (SEQ-080 or 090) and (SEQ-140 or 150 or 160) must also be checked as applicable.

(3) Then, if Filing Status (SEQ-130) is "3", Spouse Consent Indicator (SEQ-310) must be "SC".

(e) On Schedule B, if Capital Gains (SEQ-540) contains an amount greater than zero, Schedule D, Capital Gain Distribution (SEQ-1790) must have an entry or Form 1040, Capital Gain Distibution (SEQ-445) must equal "CGD".

(f) If EIC (SEQ-1180) Form 1040 is greater than zero,

(1) one or more Forms W-2 must be present;

(2) one or more Forms W-2P with Disability Indicator (SEQ-080) equal to "X";

(3) one or more Schedules C must be present;

(4) Schedule E, Appropriate Code (SEQ-1172, 1210, 1270, 1330 or 1390) must equal "P"; or

(5) Type of Other Income (SEQ-560) AND Amount of Other Income (SEQ-570) Form 1040 must be present.

(g) On Schedule C, Line 1a minus Line 1b (SEQ-220) must equal Gross Receipts/Sales (SEQ-200) minus Returns/ Allowances (SEQ-210).

(h) On Form 1040, Tax-Exempt Interest (SEQ-385) must equal or exceed Schedule B, Tax Exempt Amount (SEQ-280).

(i) On Schedule C, If Materially Participated in 1987-No (SEQ-183) equals "X" and Net Profit (Loss) (SEQ-710) is negative, then Form 8582 must be present.

(j) On Schedule C, if Amounts Not At Risk Yes (SEQ-720) equals "X" and Net Profit (Loss) (SEQ-710) is negative, then Form 6198 must be present.

(l) On Schedule E, if Actively Participate-No (A, B or C) (SEQ-039, 069 or 099) equals "X" and the corresponding Deductible Rental Loss (A, B or C) (SEQ-1103, 1105 or 1107) is significant, then Form 8582 must be present.

(m) On Schedule E, Not At Risk-Yes (SEQ-1178, 1236, 1296, 1356 or 1416) equals "X" and the corresponding Part/S-Corp Nonpassive Sch K-1 Loss (SEQ-1192, 1253, 1313, 1374 or 1433) is significant, Form 6198 must be present.

(n) On Schedule E, if Total Passive F8582 Loss (SEQ-1475) is significant, Form 8582 must be present.

Schedule A, Line 18, Casualty Theft Loss (SEQ-390)
Schedule C, Line M, Tax Shelter Registration Requirement (SEQ-195)
Schedule C, Line 28b, Jobs Credit (SEQ-430)
Schedule D, Line 14(g), Gain from Form 4797 (SEQ-1800)
Schedule D, Line 46, Sch F Bartering Income (SEQ-2150)
Schedule E, Line 28, Net Farm Rental Profit/Loss (SEQ-1140)
Form 6251, Line 16, Foreign Tax Credit (SEQ-330)
Form 6252, Line 8, Income Recapture F4797 (SEQ-150)
Form 8283, Line B2, Property Type - Art $20,000 or More (SEQ-641)

Form/ Schedule	*Line Title*	*Sequence Number*	*Line Number*
1040	Primary SSN	010	
1040	Name Control	050	
1040	First Name Line	060	
1040	Street Address	080	
1040	City	083	
1040	State	087	
1040	Filing Status	130	1-5
*1040	Exempt Self	160	6a
1040	Total Exemptions	360	6e
1040	Overpaid	1260	62

* Exception: Exempt Self (SEQ-160) must be blank when Dependent Indicator (SEQ-785) equals "X" and vice versa. When Exempt Self is blank and Dependent Indicator equals "X", then Total Exemptions (SEQ-360) must be equal to or greater than "00'.

(o) On Schedule E, if Total Passive F8582 Loss (SEQ-1923) is significant, Form 8582 must be present.

(p) On Schedule A, if Form 8598 Indicator (SEQ-155) equals "X", then Form 8598 must be present.

(q) On Schedule A, if Non-Cash Contrib (SEQ-360) is $500 or more, Form 8283 must be present.

(r) On Form 1040, if Number of Children Not Living With You Due to Divorce or Separation (SEQ-247) is significant, then

(1) Pre-1985 Agreement Box (SEQ-355) must equal "X", or

(2) Form 8332, Exemption for Non-Custodial Parent, Paper Document Indicator 3, Field 29 in the Summary Record must equal "1", or

(3) Form 2120, Multiple Support Agreement, Paper Document Indicator 2, Field 28 in the Summary Record must equal "1".

49 The Primary Social Security Number (SEQ-010) and Secondary Social Security Number (SEQ-030) when not "NRA" must be all numerics, cannot be all blanks, zeroes or all nines. In addition, it must fall within the following acceptable ranges:

(a) 001-01-0000 through 626-99-9999;and

(b) 700-00-0000 through 728-99-9999

NOTE: For additional information, see Sec. 17.03.

50 The minimum validation requirements for Taxpayer Name and Address Data are as follows:

Note: See Sec. 16 for specific instructions for entering name and address data.

(a) Name Control (SEQ-050) must equal the first four significant characters of the taxpayer's last name. No leading or embedded spaces are allowed. The two leftmost positions must be alpha. Only alpha, hyphen and space are allowed.

(b) Name Line 1 (SEQ-060) can have no leading or consecutive embedded spaces. The only characters allowed are alpha, space, ampersand (&), hyphen (-), and less-than (<). The rightmost position must be alpha. The less-than sign must immediately precede the last name and cannot be preceded or followed by a space.

(c) Name Line 2 (SEQ-070) is alphanumeric and can have no leading or consecutive embedded spaces. The only special characters allowed are space, ampersand (&), hyphen (-), slash (/) and percent (%).

(d) Street Address (SEQ-080) is alphanumeric and can have no leading or consecutive embedded spaces. The only special characters allowed are space, ampersand (&), hyphen (-), slash (/) and percent (%).

(e) City (SEQ-083) is alphanumeric and can have no leading or consecutive embedded spaces. The only special characters allowed are space, ampersand (&), hyphen (-) and percent (%).

Line From Form 1040							
Seq	*Title*	*Line #*		*Sch/Form*	*SEQ-#*	*Title*	*Line #*
*380	Taxable Interest (If > $400)	8	=	Sch. B	290	Taxable Interest	3
*395	Dividend Income (If > $400)	10	=	Sch. B	580	Taxable Dividends	9
**440	Business Income	13	=	Sch. C	710	Net Profit (Loss)	31
If SEQ-445, Capital Gain Distribution, is blank; then							
450	Capital Gain/Loss	14	=	Sch. D	1850	Line 8 Plus Line 17	18
			or	Sch. D	1865	Smaller of Line 18 Loss or Maximum	19
510	Rent/Royalty/Part/Estates/Trusts Inc	17	=	Sch. E	1150	Total Income or Loss	29
			or	Sch. E	2010	Total Supplemental Income (Loss)	42
**620	Reimbursed Employee Business Expense	23	=	2106	079	Sum of Line 12, Col A, and Line 12, Col B	13
789	Total Itemized	33a	=	Sch. A	520	Total Deductions	26
If SEQ-845, Sch. D Block equals "X"; then							
860	Tax	37	=	Sch. D	1907	Line 26 Plus Line 27	28
925	Credit for Child & Dependent Care	40	=	2441	120	Line 6 Plus Line 7	8
930	Credit For Elderly or Disabled	41	=	Sch. R	250	Credit	21
If SEQ-1035, Exempt SE Tax Indicator, is blank and Sch. SE SEQ-025, Exempt/Form 4361 Box is also blank; then							
**1040	Self-Employment Tax	48	=	Sch. SE	190	Self-Employment Tax	14
1050	Alternative Minimum Tax	49	=	6251	340	Alternative Minimum Tax	19

Line From Schedule A							
Seq #	*Title*	*Line #*		*Sch/Form*	*SEQ-#*	*Title*	*Line #*
395	Moving Expenses	19	=	3903	180	Moving Exp Deduction	29
**405	Unreimbursed Employee Business Expense	20	=	2106	125	Total Line 16, Col A and Line 16, Col B	17

* Do not perform check unless amount exceeded.

** If multiple schedules/forms are present, add bottom line amounts from each and compare total to carry-forward line.

(f) State Abbreviation (SEQ-087) must be alpha and consistent with the standard state abbreviations issued by the Postal Service. (Refer to the table of State Abbreviations in Sec. 16.04.)

51 When Direct Deposit data is present, then

(a) the Routing Transit Number (SEQ-1330), Account Number (SEQ-1340), Source Code (SEQ-1350), Account Type (SEQ-1360) and Ownership Indicator (SEQ-1370) in the Return record must equal the Routing Transit Number (Field 36), Account Number (Field 37), Source Code (Field 38 Account Type (Field 39) and Ownership Indicator (Field 40) in the Summary record;

(b) the Routing Transit Number (SEQ-1330) must be nine numerics;

(c) the Account Number (SEQ-1340) must be alphanumeric (i. e., numerics and hyphens only) and left-justified with trailing blanks if less than 17 positions;

(d) the Account Type (SEQ-1350) must be "C" or "S";

(e) the Source Code (SEQ-1360) must be "2" or "3";

(f) the Ownership Indicator (SEQ-1370) must be "0", "1", "2" or "3";

(g) the Account Number (SEQ-1340) cannot equal an Account Number on a previously accepted return unless the Filing Status (SEQ-130) equals "3";

(h) if Ownership Indicator (SEQ-1370) equals "0", Filing Status (SEQ-130 of the return record) must equal "1", "3", "4" or "5";

(i) If Ownership Indicator (SEQ-1370) equals "1" or "2", Filing Status (SEQ-130 of the return record) must be "2";

(j) If Ownership Indicator (SEQ-1370) is "3", Filing Status (SEQ-130 of the return record) must equal "2" or "3".

52. If Paid Preparer information is present in the Summary Record (Fields 4 through 11), then Preparer Firm EIN (Field 7) and/or Preparer SSN (Field 5) must be numerics and not equal to all nines or all zeroes.

53. If Form W-2, Form W-2G and/or Form W-2P are present, then Employer (Payer) Identification Number (SEQ-030) or Employer (Payer) Name (SEQ-020) must be present for each form record.

Sec. 15 Form 1040EZ/1040A Conversion Guide

1 If the return was prepared as a Form 1040EZ or could have been prepared as a 1040EZ, the following fields are applicable:

Sequence Number	Field Identification
010	Primary SSN
050	Name Control
060	Name Line 1
070	Name Line 2
080	Street Address
083	City
087	State Abbreviation
095	Zip Code
110	PECF 1 Yes
115	PECF 1 No
130	Filing Status
160	Exempt Self
167	Total Box 6a and 6b
360	Total Exemptions
375	Wages, Salaries, Tips (Line 1, F1040EZ)
380	Taxable Interest (Line 2, F1040EZ)
385	Tax-Exempt Interest (Line 2, F1040EZ)
600	Total Income (same as AGI)
750	Adjusted Gross Income (Line 3, F1040EZ)
770	AGI Repeated
785	Dependent Indicator (Line 4, Yes Box)
798	Standard Deduction (Line 4, F1040EZ)
800	Line 31 Less Line 33a or 33b (Line 5, F1040EZ)
810	Exemption Amount (Line 6, F1040EZ)
820	Taxable Income (Line 7, F1040EZ)
830	Tax Table Block
860	Tax (Line 9, F1040EZ)
920	Total Taxes Before Credits (repeat SEQ-860)
980	Tax Less Personal Credits (repeat SEQ-860)
1030	Tax Less Business & Other Credits (repeat SEQ-860)
1130	Total Tax (repeat SEQ-860)
1140	1099/1099R Indicator
1160	Withholding (Line 8, F1040EZ)
1200	Excess SS Tax
1250	Total Payments (SEQ-1160 plus SEQ-1200)
1260	Overpaid (repeat SEQ-1270)
1270	Refund (Line 10, F1040EZ)

2 If the return was prepared as a Form 1040A or could have been prepared as a 1040A, the following fields are applicable:

Sequence Number	Field Identification
007	Divorce Indicator
009	Divorced SSN
010	Primary SSN
030	Secondary SSN
050	Name Control
060	Name Line 1
070	Name Line 2
080	Street Address
083	City
087	State Abbreviation.
095	Zip Code
110	PECF 1 Yes
115	PECF 1 No
120	PECF 2 Yes
125	PECF 2 No
130	Filing Status (Line 1, 2, 3 or 4, F1040A)
140	Spouse's Name (Line 3, F1040A)
150	Qualifying Name (Line 4, F1040A)
160	Exempt Self (Line 5a, F1040A)
163	Exempt Spouse (Line 5b, F1040A)
167	Total Box 6a and 6b (Total Box 5a and 5b, F1040A)
*171	Dependent Name-1 (Line 5c, col.1, F1040A)
+173	Under Age 5-1 (Line 5c, col.2, F1040A)
+175	Dependent's SSN-1 (Line 5c, col.3, F1040A)
+177	Relationship-1 (Line 5c, col.4, F1040A)
+179	Number of Months-1 (Line 5c, col.5, F1040A)
181	Dependent Name-2
183	Under Age 5-2
185	Dependent's SSN-2
187	Relationship-2
189	Number of Months-2
191	Dependent Name-3
193	Under Age 5-3
195	Dependent's SSN-3
197	Relationship-3
199	Number of Months-3
201	Dependent Name-4
203	Under Age 5-4
205	Dependent's SSN-4
207	Relationship-4
209	Number of Months-4
211	Dependent Name-4
213	Under Age 5-5
215	Dependent's SSN-5
217	Relationship-5
219	Number of Months-5
221	Dependent Name-6
223	Under Age 5-6
225	Dependent's SSN-6
227	Relationship-6
229	Number of Months-6
231	Dependent Name-7
233	Under Age 5-7
235	Dependent's SSN-7
237	Relationship-7
239	Number of Months-7
240	Number of Children Who Lived With You
247	Number of Children Not Living With You Due to Divorce or Separation
253	Number of Parents Listed
350	Number of Other Dependents Listed
355	Pre-1985 Agreement Box
360	Total Exemptions (Line 5e,F1040A)
370	Fringe Benefit Indicator
375	Wages, Salaries, Tips (Line 6, F1040A)
380	Taxable Interest (Line 7, F1040A)
385	Tax-Exempt Interest
395	Dividend Income (Line 8, F1040A)
545	Unemployment Compensation (Line 9, F1040A)
551	Repayment
552	Repayment Amount
600	Total Income (Line 10, F1040A)
625	IRA Deduction Self (Line 11a, F1040A)
635	IRA Deduction Spouse (Line 11b, F1040A)

740	Total Adjustments
750	Adjusted Gross Income (Line 12, F1040A)
770	AGI Repeated (Line 13, F1040A)
772	Self 65 or Over Box
774	Self Blind Box
776	Spouse 65 or Over Box
778	Spouse Blind Box
783	Total Boxes Checked (Line 14a, F1040A)
785	Dependent Indicator
787	Must Itemize Indicator
798	Standard Deduction (Line 14d, F1040A)
800	Line 31 Minus Line 33a or 33b (Line 15, F1040A)
810	Exemption Amount (Line 16, F1040A)
820	Taxable Income (Line 17, F1040A)
825	Under 14 With Unearned Income
830	Tax Table Block
860	Tax (Line 18, F1040A)
920	Total Taxes Before Credits (repeat SEQ-860)
925	Credit for Child & Dependent Care (Line 19, F1040A)
970	Total Personal Credits (repeat SEQ-925)
980	Tax Less Personal Credits (Line 20, F1040A)
1030	Tax Less Business & Other Credits (repeat SEQ-980)
1110	Other Tax Literals ("AEIC" only)
1120	Other Tax Amount
1125	Total Other Tax Amount
1130	Total Tax (Line 20, F1040A)
1140	1099/1099R Indicator
1160	Withholding (Line 21a, F1040A)
1173	Nontaxable Compensation Literal
1175	Child's Name
1180	Earned Income Credit (Line 21b, F1040A)
1183	EIC Eligibility
1200	Excess SS Tax
1250	Total Payments (Line 22, F1040A)
1260	Overpaid (repeat SEQ-1270)
1270	Refund (Line 23, F1040A)
1323	Occupation
1327	Spouse Occupation

Form 2441 (Schedule 1-Part I)

Sequence Number	Field Identification
010	Number of Qualifying Persons (Line 1, Part I)
040	Expenses (Line 2, Part I)
050	Earned Income (Line 3a, Part I)
060	Spouses Income (Line 3b, Part I)
070	Smaller Income (Line 3c, Part I)
080	Smaller of Line 2 or Line 3a or 3b (Line 4, Part I)
090	Applicable Percentage (Line 5, Part I)
120	Line 6 plus Line 7 (Line 6, Part I)

Schedule B (Schedule 1-Part II)

Sequence Number	Field Identification
*030	Interest Payer 1 (Line 1, Part II)
+040	Interest Amount 1 (Line 1, Part II)
050	Interest Payer 2
060	Interest Amount 2
070	Interest Payer 3
080	Interest Amount 3
090	Interest Payer 4
100	Interest Amount 4
110	Interest Payer 5
120	Interest Amount 5
130	Interest Payer 6
140	Interest Amount 6
150	Interest Payer 7
155	Interest Amount 7
160	Interest Payer 8
170	Interest Amount 8
220	Interest Subtotal
270	Tax-Exempt Literal
280	Tax Exempt Amount
290	Taxable Interest (Line 2, Part II)

Schedule B continued (Schedule 1-Part III)

Sequence Number	Field Identification
*300	Dividend Payer 1 (Line 1, Part III)
+310	Divident Amount 1 (Line 1, Part III)
320	Dividend Payer 2
330	Dividend Amount 2
340	Dividend Payer 3
350	Dividend Amount 3
360	Dividend Payer 4
370	Dividend Amount 4
380	Dividend Payer 5
390	Dividend Amount 5
400	Dividend Payer 6
410	Dividend Amount 6
420	Dividend Payer 7
430	Dividend Amount 7
440	Dividend Payer 8
450	Dividend Amount 8
460	Dividend Payer 9
470	Dividend Amount 9
480	Dividend Payer 10
490	Dividend Amount 10
580	Taxable Dividends (Line 2, Part III)

Sec. 16 Special Instructions for Entering Taxpayer's Name and Address

.01 These instructions must be carefully followed to avoid delaying returns for error conditions. They must be included in electronic filers' programs as consistency tests and in the data entry instructions.

Caution: All entity data, i.e., SSN, name, street address, city, state and zip code should be *key verified* to avoid lengthy delays caused by mismatches with the existing taxpayer information on IRS records or by undeliverable refund checks.

.02 Name Line 1

1 Only alphabetic characters, spaces and the special characters Less-Than (<), ampersand (&) and hyphen (-) may appear in Name Line 1.

2 Only one intervening space may separate any component of a name line. The special character Less-Than replaces an intervening space to identify the primary taxpayer's last name.

3 All apostrophes and any other punctuation characters except hyphen must be omitted from names and the alphabetic characters shifted to the left in their place (e.g., O'Shea = OSHEA).

4 Numeric Characters in name components must be replaced by alphabetic Roman Numerals (e.g., Charles 3rd = CHARLES III 5 Enter a Less-Than (<) before the last name of the primary taxpayer. Enter a Less-Than after the name only if a title suffix follows (e.g., "III"). Do not enter a space before or after any Less-Than; the Less-Than takes the place of a space.

6 Enter first name, space, middle name or initial, Less-Than, last name. (The last name(s) of the individuals must be completed within this name line field.) If there is a suffix, enter a Less-Than between the last name and the suffix. Joint returns *must* contain one ampersand (&) between taxpayers' first names. The taxpayer whose first name is associated with the Primary SSN used on the return must be entered first and the last name of that taxpayer must be identified by a preceding Less-Than. If spouses use different last names, the primary taxpayer's first and last name appear first, with the last name bracketed by Less-Thans followed by an ampersand and the full name of the spouse.

.03 Instructions for Street Address and Name Line 2

1 Only alphabetic and numeric characters, ampersand (&), hyphen (-), percent (%), slash (/) and spaces appear in the Street Address and Name Line 2 fields.

2 Name Line 2 will be used for street addresses that require two lines or "In Care Of" address. An "In Care of" address must be indicated by a percent character (%) followed by the name which is in care of delivery.

3 Enter the house number and street, route number, post office box, or box number.

4 Abbreviate words requiring standard abbreviations unless the word is a proper name.

Examples	*Enter As*
South Court Street	S COURT ST
Circle Drive	CIRCLE DR
Lane Building	LANE BLDG
Northeast Street	NORTHEAST ST
Third Street	THIRD ST
3 Ave.	3RD AVE

5 If two addresses are present, enter the address shown immediately above

or before the city and state in the Street Address field. The remaining address should be entered in the Name Line 2 field.

6 Enter college, building, post office branch as the address if no mailing address is given.

7 If "In Care Of" is the mailing address, use the symbol "%" followed by a space.

8 Do not use "#" symbol, "No.", and "Number" as a prefix to a house, apt., route, or P.O. Box.

9 Always add st, nd, rd, th, to a numbered street or avenue. Examples: 1 = 1ST; 2 = 2ND; 3 = 3RD, etc.

10 Enter 1/2 as 1/2 (no spaces).

11 Plurals for street, road, avenue, apartment, etc., will be entered as STS, RDS, AVES, APTS, etc.

12 Omit the letters "APO" and "FPO" in the address. Transcribe the five digits following the "APO" or "FPO" as the Zip Code, left-justified.

13 Space for all periods in the address line.

14 When it is necessary to abbreviate street address data, see Attachment XV for recommended abbreviations.

.04 Instructions for City, State and Zip Code Fields

1 The City field may contain only alphabetic or numeric characters, ampersand, percent, hyphen or spaces.

2 Attachment XVI contains the standard Postal Service state abbreviations which must be used for the State Abbreviation field and the valid range of the corresponding three high order zip code digits for each state.

.05 Special Instructions for Determining the IRS Name Control Field

1 The Name Control consists of the first four significant characters of the individual's last name whose social security number is the Primary SSN for the return being filed. There should be no leading or embedded blanks in the name control. Omit punctuation marks, titles and suffixes.

2 Consider certain foreign suffixes as part of the last name (i.e., Armah-Bey, Paz-Ayala, Allar-Sid). Particular attention must be given to those names which incorporate a mother's maiden name as a suffix to the last name. This practice is common in names of Spanish extraction. Consider the mother's maiden name as part of the surname for Name Control purposes.

Examples	Enter As
Henry A. (Carter)*	HENRY A < CARTER
John A. and Jane B. (Smith)	JOHN A & JANE B < SMITH
Carl A. (Jones) & Angie Myer	CARL A < JONES < & ANGIE MYER
J. B. (Smith) Jr. & Ann Trent	J B < SMITH < JR & ANN TRENT
Florence E. (Jones) M. D.	FLORENCE E < JONES < MD
Alfred (Newman) Minor	ALFRED < NEWMAN < MINOR
Frank N. (De Porta)	FRANK N < DE PORTA
Lillie B. (Owen-Smith)	LILLIE B < OWEN-SMITH
John M (Brown), M.D.	JOHN M < BROWN < MD
James R. (O'Donnell)	JAMES R < ODONNELL
John C. (Brown), III	JOHN C < BROWN < III
Timothy (Jackson), 2nd	TIMOTHY < JACKSON < II
James (Oliver-Keogh), 3rd	JAMES < OLIVER-KEOGH < III

* Parentheses illustrate last name of taxpayer with primary SSN.

Example 1:	Mr. John Jones 801 N. Erie Street P.O. Box 1502 Toledo, OH 43603	
Enter As:	JOHN < JONES	(First Name Line)
	801 N ERIE ST	(Second Name Line)
	PO BOX 1502	(Street Address)
Example 2:	Mr. John Jones P.O. Box 1502 801 N. Erie St., Toledo, OH 43603	
Enter As:	JOHN < JONES	(First Name Line)
	PO BOX 1502	(Second Name Line)
	801 N ERIE ST	(Street Address)
Example:	Mr. John Jones In Care of Alice B. Smith 801 Brown St.	
Enter As:	JOHN < JONES	(Name Line 1)
	% ALICE SMITH	(Name Line 2)
	801 BROWN ST	(Street Address)

SEC. 17 Refund Delay Criteria and Preparer Front End Checks

.01 The following conditions may delay refunds and/or change refund amounts.

1 Taxpayer owes back taxes, either individual or business (refund will be offset).

2 Taxpayer owes delinquent child support (refund offset).

3 Taxpayer has certain delinquent federal debit, such as student loans, etc. (refund offset).

4 The last name and social security number of the primary taxpayer must be the same as on last year's return or the return will be delayed at least one week for rematching.

5 The Estimated Tax payments reported on the return do not match the ES Tax Payments recorded on the IRS master file. This generally occurs when:

(a) the spouse made separate payments and filed a joint return or vice versa; or

(b) the return was filed before the last ES payment was credited to the account.

6 The taxpayer has a Schedule E claiming a deduction for a questionable tax shelter.

7 The taxpayer is claiming a blatantly unallowable deduction.

.02 The following are conditions under which correctly prepared tax returns are automatically subject to manual review which could delay the refund.

1 The Wages amount on the return record equals the maximum amount for Social Security Wages (Wages equal $43,800 or $87,600 for tax year 1987).

2 IRA Deduction Self and IRA Deduction Spouse equals Withholding or Estimated Tax Credits or the sum of the two.

3 Withholding equals the amount which should have been withheld for Social Security or RRTA Taxes.

4 The Refund amount is $500,000 or more.

.03 Optional Social Security Number Validation

Preparers may wish to make a computer check on the validity of the SSN's of those taxpayers who have IRS preprinted mailing labels to prevent transcription errors that would result in delayed refunds. The two alpha characters which appear to the right of the SSN on the IRS label are check digits which are used to verify the SSN. Use the following formula to validate the transcription of the SSN when the taxpayer presents an IRS mailing label:

1 Generate the high order check digit by multiplying the specific digits by the appropriate weight multiple.

Digit of the SSN	*Times*	*Weight Multiple*
1st position (high order)	×	+1
2nd position	×	+2
3rd position	×	-4
4th position	×	+1
5th position	×	+2
6th position	×	-4
7th position	×	+1
8th position	×	+2
9th position	×	-4

2 Add the products to an accumulator. If the net results of the accumulation is within the range of 0 through-22, select the alphabetical equivalent from the alphabetic table below. If the net result is outside the range of the table, check the sign of the accumulation. If the sign is plus, subtract 23 from the result; if the sign is minus, add 23 to the result. Repeat this until the result is within the range of the table and select the alphabetic equivalent from the table for the high order position of the check digit.

3 Generate the low order position of the check digit by multiplying the specific digits by the appropriate weight multiple.

Digit of the SSN	*Times*	*Weight Multiple*
1st position (high order)	×	+1
1st position (low order)	×	+1
2nd position	×	-3
3rd position	×	+1
4th position	×	-3
5th position	×	+1
6th position	×	-3
7th position	×	+1
8th position	×	-3
9th position	×	+1

4 Add the products to an accumulator and repeat the calculation in 2. above to arrive at the low order position of the check digit.

5 Alphabetic Table

0 = A -8 = K -16 = T
-1 = B -9 = L -17 = U
-2 = C -10 = N -18 = V
-3 = D -11 = O -19 = W
-4 = F -12 = P -20 = X
-5 = H -13 = Q -21 = Y
-6 = I -14 = R -22 = Z
-7 = J -15 = S

.04 For taxpayers without preprinted mailing labels, the following ranges of Social Security Numbers are invalid and will delay the issuance of the refund for several weeks.

1. 000-00-0000 through 001-00-9999
2. 627-00-0000 through 699-99-9999
3. 729-00-0000 through 899-99-9999

Sec. 18 Valid Statement References and Related Fields

1. The following asterisked "*" fields may contain the literal "STMbnn".

2. The following "" sign fields must contain the Literal "STMbnn" if significant.

3. The following fields on the "RETb", "SCHb" or "FRMb" record should reflect the total of the money fields reported on the respective "STMbnn" record. If no "STMb" is required, the applicable money amount should be reported in the specific field and repeated in the "Total" field.

Examples	*Individual Name*	*Name Control*
	John Brown	BROW
	John Lea-Smith	LEA-
	John Di Angelo	DIAN
	John O'Neil	ONEI
	John En, Sr.	EN
	Pedro Paz-Ayala	PAZ-
	Abdullah Allar-Sid	ALLA
	Joe McCarty	MCCA
	Juan de la Rosa Y Obregon	DELA
	Jose Alvarado Nogales	ALVA
	Donald Vander Neut	VAND
	Otto Von Wodtke	VONW
	Mary Smith & John Jones	SMIT

FORM/SCH		SEQUENCE NO	IDENTIFICATION	LINE REFERENCE
1040	PG01	171	Dependent Name-1	6(c)1
		560	Type of Other Income	21
		690	Recipient Last Name	28
		720	Other Adjustments Literal	29
1040	PG02	1110	Other Tax Literal	53
A	PG01	040	Other Medical Type 1	1c
		130	Other Taxes Type	7
		170	Individual Mortgage Name	9b
		310	Cash $3000 or More Org Name 1	14b
		420	Other Expenses Type	21
		475	Misc Expenses Not Subject to 2% Limit Type	

FORM/SCH		SEQUENCE NO	IDENTIFICATION	LINE REFERENCE
B	PG01	010	Seller Financed Mortgage Name	1
		030	Interest Payer 1	2
		300	Dividend Payer 1	4
C	PG01	140	Type of Other Method	F(3)
		500	Other Expense Type 1	
D	PG01	020	Short F1099-B Desc 1	2a(a)1
		650	Other Short Desc 1	2c(a)1
		880	Long F1099-B Desc 1	9a(a)1
		1510	Long Other Desc 1	9c(a)1
D	PG02	2155	Other Bartering Income Description	47
E	PG01	570	Other-Description 1	A-19-1
E	PG02	1170	Part/S-Corp Name A	A(a)
		1790	Estate/Trust Name A	
		1953	REMIC Name	38(a)
4562	PG01	020	Class of Property 1	1(a)-1
		100	3-Year Cost	6a(c)
		140	5-Year Cost	6b(c)
		172	7-Year Cost	6c(c)
		180	10-Year Cost	6d(c)
		220	15-Year Cost	6e(c)
		275	20-Year Cost	6f(c)
		313	Residential Rental Prop Date in Service 1	6g(b)1
		363	Nonresidential Real Prop Date in Service 1	6h(b)1
		510	Descrip of Prop 1	II-1(a)1
4562	PG02	770	Description 1	III(a)1
		1610	Total Miles 1	IIIB1-1
		1850	Vehicle Available Yes	IIIB5-1
6198	PG01	033	Other Gain/Loss Type	2c
8283	PG01	010	Donee Organization A	A1a
		210	Contribution Date A	Ac
		457	Property ID Letter	2a
8283	PG02	650	Descrip of Prop (1)	B3a
8606	PG01	020	Trustee Name 1	1a
A	PG01	165	Form 1098 Name and Address	9a
C	PG01	100	Other Method Explanation	E(3)
		153	ChangeInventory Change Method Explanation	G
		333	Form 1098 Name/Address	17
D	PG01	015	F1099-B Explanation of Difference	1
D	PG02	2170	Non-Taxable Explanation	47
E	PG01	385	Form 1098 Name/Address	12
4562	PG01	475	Line 9 Explanation	9
6252	PG01	380	Explanation of Disp Not to Avoid Tax	H
1040	PG01	590	Total Other Income	21
		697	Total Alimony Paid	28
		735	Total Other Adjustments	29
1040	PG02	1125	Total Other Tax	53
A	PG01	050	Total Other Medical	1c
		140	Total Other Taxes Amount	7
		195	Total Individual Mortgage Amount	9b
		350	Total Cash $3000 or More	14b
		435	Total Other Expenses	21
		495	Total Misc Expenses Not Subject to 2% Limit	25
B	PG01	025	Total Seller Financed Mortgage Amount	1
D	PG02	2165	Total Other Bartering Income	47
6198	PG01	040	Total Other Gain/Loss	2c

Section 1 Form 1040, Page 1

An asterisk (*) precedes any field which may contain a statement reference (STMbnn) indicating either the first entry of a line or table of related items to be continued on a statement record. When present, a plus-sign (+) precedes the items related to the first entry field. An at-sign (@) precedes any field which must contain a statement reference when significant. In some cases, the related statement fields require more than the maximum 80 positions allowed, such as Schedule E, Page 2, Part/S Corp Name A (SEQ-1170). An asterisk followed by a plus sign (*+) indicates the first field of a separate statement record which continues the required related fields from the previous statement record.

Field No.	*Identification*	*Form Ref.*	*Length*	*Field Description*
	Byte Count, Page 1		4	"1121" for fixed; "nnnn" for variable format
000	Record ID		62	Value "RETb1040b-bnbPG0lb (9n)b8712b(30n)" (9n = Primary SSN; 30n = Return Sequence Number & Declaration Control Number)
007	Divorce Indicator		3	"DIV" or blank
009	Divorced SSN		9	SSN of divorced spouse for ES credit allocation
010	Primary SSN		9	Numeric (Your social security number block)
020	Primary Date of Death		6	NO ENTRY
030	Secondary SSN		9	Numeric (Spouse social security number block or literal "NRAbbbbbb" if spouse is non-resident alien with no SSN or income)
040	Secondary Date of Death		6	NO ENTRY
050	Name Control		4	First 4 significant characters of taxpayer's last name, no leading or embedded spaces; allowable characters are alpha, hyphen, or space (see special instructions)
060	Name Line 1		35	Alpha, Taxpayer's name, allowable special characters are: space, less-than (X), hyphen (-), and ampersand (&).
070	Name Line 2		35	Alphanumeric, in care of addressee, or address continuation. Allowable special characters are space, ampersand, slash hyphen, and percent (%).
080	Street Address		35	Alphanumeric. Allowable special characters are space, ampersand, slash hyphen, and percent.
083	City		22	Alphanumeric. Allowable special characters are ampersand, hyphen, percent, and spaces.
087	State Abbreviation		2	Alpha (Standard Postal State Abbreviations)
095	Zip Code		9	Numeric (left-justified)
110	PECF 1 Yes		1	Value "X" or blank
115	PECF 1 No		1	Value "X" or blank
120	PECF 2 Yes		1	Value "X" or blank
125	PECF 2 No		1	Value "X" or blank
130	Filing Status	1-5	1	Value 1, 2, 3, 4, or 5 (Applicable block, line 1-5)
140	Spouse's Name	3	25	Alpha (must be present if status 3, otherwise blank)
150	Qualifying Name for H of Household	4	25	Alpha or blank
155	Year Spouse Died	5	2	Numeric
160	Exempt Self	6a	1	Value "X" or blank
163	Exempt Spouse	6b	1	Value "X" or blank
167	Total Box 6a and 6b		1	Values 0, 1 or 2
*171	Dependent Name—1	6c(1)	25	Alpha (first name,space, middle initial, space, last name) or "STMbnn"
+173	Under Age 5—1	6c(2)	1	Value "X" or blank
+175	Dependent's SSN—1	6c(3)	9	Alphanumeric, "APPLIED", "EXEMPT", "AMISH", "MENNONITE", "MEXICAN", "CANADIAN" or blank

Field No.	*Identification*	*Form Ref.*	*Length*	*Field Description*
+177	Relationship—1	6c(4)	11	Values: "CHILD", "GRANDCHILD", "GRANDPARENT", "PARENT", "BROTHER", "SISTER", "AUNT", "UNCLE", "NEPHEW", "NIECE", "NONE" or blank
+179	Number of Months—1 6c(5)		2	Range 00-12, Db, Bb or blank
181	Dependent Name—2	6c(1)	25	Alpha (first name,space, middle initial, space, last name)
183	Under Age 5—2	6c(2)	1	Value "X" or blank
185	Dependent's SSN—2	6c(3)	9	Alphanumeric, "APPLIED", "EXEMPT", "AMISH", "MENNONITE", "MEXICAN", "CANADIAN" or blank
187	Relationship—2	6c(4)	11	Values: "CHILD", "GRANDCHILD", "GRANDPARENT", "PARENT", "BROTHER", "SISTER", "AUNT", "UNCLE", "NEPHEW", "NIECE", "NONE" or blank
189	Number of Months—2 6c(5)		2	Range 00-12, Db, Bb or blank
191	Dependent Name—3	6c(1)	25	Alpha (first name,space, middle initial, space, last name)
193	Under Age 5—3	6c(2)	1	Value "X" or blank
195	Dependent's SSN—3	6c(3)	9	Alphanumeric, "APPLIED", "EXEMPT", "AMISH", "MENNONITE", "MEXICAN", "CANADIAN" or blank
197	Relationship—3	6c(4)	11	Values: "CHILD", "GRANDCHILD", "GRANDPARENT", "PARENT", "BROTHER", "SISTER", "AUNT", "UNCLE", "NEPHEW", "NIECE", "NONE" or blank
199	Number of Months—3 6c(5)		2	Range 00-12, Db, Bb or blank
201	Dependent Name—4	6c(1)	25	Alpha (first name, space, middle initial, space, last name)
203	Under Age 5—4	6c(2)	1	Value "X" or blank
205	Dependent's SSN—4	6c(3)	9	Alphanumeric, "APPLIED", "EXEMPT", "AMISH", "MENNONITE", "MEXICAN", "CANADIAN" or blank
207	Relationship-4	6c(4)	11	Values: "CHILD", "GRANDCHILD", "GRANDPARENT", "PARENT", "BROTHER", "SISTER", "AUNT", "UNCLE", "NEPHEW", "NIECE", "NONE" or blank
209	Number of Months—4 6c(5)		2	Range 00-12, Db, Bb or blank
211	Dependent Name—5	6c(1)	25	Alpha (first name, space, middle initial, space, last name)
213	Under Age 5—5	6c(2)	1	Value "X" or blank
215	Dependent's SSN—5	6c(3)	9	Alphanumeric, "APPLIED", "EXEMPT", "AMISH", "MENNONITE", "MEXICAN", "CANADIAN" or blank
217	Relationship—5	6c(4)	11	Values: "CHILD", "GRANDCHILD", "GRANDPARENT", "PARENT", "BROTHER", "SISTER", "AUNT", "UNCLE", "NEPHEW", "NIECE", "NONE" or blank
219	Number of Months—5 6c(5)		2	Range 00-12, Db, Bb or blank
221	Dependent Name—6	6c(1)	25	Alpha (first name, space, middle initial, space, last name)
223	Under Age 5—6	6c(2)	1	Value "X" or blank
225	Dependent's SSN—6	6c(3)	9	Alphanumeric, "APPLIED", "EXEMPT", "AMISH", "MENNONITE", "MEXICAN", "CANADIAN" or blank
227	Relationship—6	6c(4)	11	Values: "CHILD", "GRANDCHILD", "GRANDPARENT", "PARENT", "BROTHER", "SISTER", "AUNT", "UNCLE", "NEPHEW", "NIECE", "NONE" or blank
229	Number of Months—6 6c(5)		2	Range 00-12, Db, Bb or blank
231	Dependent Name—7	6c(1)	25	Alpha (first name, space, middle initial, space, last name)
233	Under Age 5—7	6c(2)	1	Value "X" or blank
235	Dependent's SSN—7	6c(3)	9	Alphanumeric, "APPLIED", "EXEMPT", "AMISH", "MENNONITE", "MEXICAN", "CANADIAN" or blank

Field No.	Identification	Form Ref.	Length	Field Description
237	Relationship—7	6c(4)	11	Values: "CHILD", "GRANDCHILD", "GRANDPARENT", "PARENT", "BROTHER", "SISTER", "AUNT", "UNCLE", "NEPHEW", "NIECE", "NONE" or blank
239	Number of Months—7 6c(5)		2	Range 00-12, Db, Bb or blank
240	Number of Children Who Lived with You	6c	2	Value 00-99
247	Number of Children Not Living With You Due to Divorce or Separation	6c	2	Value 00-99
253	Number of Parents Listed	6c	1	Value 0-9
350	Number of Other Dependents Listed	6c	2	Value 00-99
355	Pre-1985 Agreement Box	6d	1	Value "X" or blank
360	Total Exemptions	6e	2	Value Range 00-99
370	Fringe Benefit Indicator	7	2	"FB" or blank
375	Wages, Salaries, Tips	7	12	Numeric
380	Taxable Interest	8	12	Numeric
385	Tax-Exempt Interest	9	12	Numeric
395	Dividend Income	10	12	Numeric
420	State/Local Income Tax Refund	11	12	Numeric
430	Alimony Received	12	12	Numeric
440	Business Income/Loss	13	12	Numeric
445	Capital Gain Distribution		3	"CGD" or blank
450	Capital Gain/Loss	14	12	Numeric
470	Other Gain/Loss	15	12	NO ENTRY
485	Pensions/IRA Dist/Annuities Received	16a	12	Numeric
493	1986 Lump Sum Dist Election Literal	16b	3	"LSE" or blank
495	Taxable Amount	16b	12	Numeric
510	Rent/Royalty/Part/Estates/Trusts Inc	17	12	Numeric
520	Farm Income	18	12	NO ENTRY
545	Unemployment Compensation	19	12	Numeric
551	Repayment		9	Value "REPAYMENT"
552	Repayment Amount		12	Numeric
553	Social Security Benefits	20a	12	Numeric
557	Taxable Amount of Social Security	20b	12	Numeric
*560	Type of Other Income		25	Alphanumeric or "STMbnn"
+570	Amount of Other Income		12	Numeric
590	Total Other Income	21	12	Numeric
600	Total Income	22	12	Numeric
620	Reimbursed Employee Business Expense	23	12	Numeric
625	IRA Deduction Self	24a	12	Numeric
635	IRA Deduction Spouse	24b	12	Numeric
645	Self-Employed Health Insurance Deduction	25	12	Numeric
660	Keogh/SEP Deduction	26	12	Numeric
670	Defined Benefit		2	"DB" or blank
680	Early Withdrawal Penalty	27	12	Numeric
*690	Recipient Last Name		15	Alphanumeric or "STMbnn"
+693	Recip Soc Sec #		9	Numeric
+695	Alimony Amount		12	Numeric
697	Total Alimony Paid	28	12	Numeric
*720	Other Adjustments Literal		13	Values are "REFORESTATION", "SUB-PAYbTRA", "STMbnn" or blank
+730	Other Adjustment Amount		12	Numeric
735	Total Other Adjustments		12	Numeric
740	Total Adjustments	29	12	Numeric
750	Adjusted Gross Income	30	12	Numeric

Sec. 2 Form 1040, Page 2

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count, Page 2		4	"0687" for fixed and "nnnn" for variable format
760	Record ID		32	Value "RETb1040bbnb PG02bnnnnnnnnnb8712b" (n = Primary SSN)
770	AGI Repeated	31	12	Numeric
772	Self 65 or Over Box	32a	1	"X" or blank
774	Self Blind Box	32a	1	"X" or blank
776	Spouse 65 or Over Box	32a	1	"X" or blank
778	Spouse Blind Box	32a	1	"X" or blank
783	Total Boxes Checked	32a	1	1, 2, 3, 4 or blank
785	Dependent Indicator	32b	1	"X" or blank
787	Must Itemize Indicator	32c	1	"X" or blank
789	Total Itemized	33a	12	Numeric
798	Standard Deduction	33b	12	Numeric
800	Line 31 Less 33a or 33b	34	12	Numeric
810	Exemption Amount	35	12	Numeric
820	Taxable Income	36	12	Numeric
825	Under 14 With Unearned Income	36	1	"X" or blank
830	Tax Table Block	37	1	"X" or blank
840	Tax Rate Schedule X Y Z Block	37	1	"X" or blank
845	Schedule D Block	37	1	"X" or blank
855	Form 8615 Block	37	1	NO ENTRY
860	Tax	37	12	Numeric
870	Form 4970 Block	38	1	NO ENTRY
880	Form 4972 Block	38	1	NO ENTRY
890	(Reserved)		1	NO ENTRY
910	Additional Taxes	38	12	NO ENTRY
920	Total Taxes Before Credits	39	12	Numeric
925	Credit for Child & Dependent Care	40	12	Numeric
930	Credit for Elderly or Disabled	41	12	Numeric
970	Total Personal Credits	42	12	Numeric
980	Tax Less Personal Credits	43	12	Numeric
990	Foreign Tax Credit	44	12	NO ENTRY
1003	Form 3800 Block	45	1	NO ENTRY
1005	Form 3468 Block	45	1	NO ENTRY
1007	Form 5884 Block	45	1	NO ENTRY
1009	Form 6478 Block	45	1	NO ENTRY
1011	Form 6765 Block	45	1	NO ENTRY
1013	Form 8586 Block	45	1	NO ENTRY
1015	General Business Credit	45	12	NO ENTRY
1020	Total Business & Other Credits	46	12	NO ENTRY
1030	Tax Less Business & Other Credits	47	12	Numeric
1035	Exempt SE Tax Indicator		5	"F4029", "F4361" or blank
1040	Self Employment Tax	48	12	Numeric
1050	Alternative Minimum Tax	49	12	Numeric
1060	Recapture Investment Credit	50	12	NO ENTRY
1070	Railroad Retire Indicator		4	NO ENTRY
1080	Social Security on Tips	51	12	NO ENTRY
1100	Tax on Retirement Plans	52	12	NO ENTRY
*1110	Other Tax Literal		6	"AEICbb", "EPPbbb", "S72Pbb", "UTOTbb", "STMbnn" or blank
+1120	Other Tax Amount		12	Numeric
1125	Total Other Tax		12	Numeric
1130	Total Tax	53	12	Numeric
1140	1099/1099R Indicator		9	"FORMb1099" or blank
1160	Withholding	54	12	Numeric
1170	ES Payments	55	12	Numeric
1173	Nontaxable Compensation Literal		3	"NEI" or blank
1175	Child's Name		15	Alpha
1180	Earned Income Credit	56	12	Numeric
1183	EIC Eligibility		2	"NO" or blank
1190	Form 4368 Amount	57	12	NO ENTRY
1200	Excess SS Tax	58	12	Numeric
1210	Credit for Special Fuels Tax	59	12	NO ENTRY
1220	Form 4469 Indicator		9	NO ENTRY
1225	4469 Amount		12	NO ENTRY
1230	Regulated Investment Co	60	12	NO ENTRY
1240	Overpaid Windfall Indicator		4	NO ENTRY

Field No.	Identification	Form Ref.	Length	Field Description
1245	**Overpaid Windfall Amount**		12	NO ENTRY
1250	**Total Payments**	61	12	Numeric
1260	**Overpaid**	62	12	Numeric
1270	**Refund**	63	12	Numeric
1280	**Applied to ES**	64	12	Numeric
1290	**Amount Owed**	65	12	NO ENTRY
1300	Form 2210 Indicator		1	NO ENTRY
1310	ES Penalty Amount		12	NO ENTRY
1320	Remittance		12	NO ENTRY
1323	Occupation		25	Alphanumeric
1327	Spouse Occupation		25	Alphanumeric
1330	Routing Transit Number		9	Numeric
1340	Account Number		17	Alphanumeric (includes hyphens)
1350	Source Code		1	Value = 2, 3 or blank
1360	Account Type		1	Value = S, C or blank
1370	Ownership Indicator		1	Value = 0, 1, 2, 3 or blank
1380	Refund Indicator (IRS Use Only)		1	NO ENTRY

SEC. 3 Schedule A

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"0732" for fixed; "nnnn" for variable format
000	Record ID		26	Value "SCHbAbbbbbnb PG01bnnnnnnnnn" (n = P-SSN)
010	Medicine/Drugs/Doctors	1a	12	Numeric
030	Transportation/Lodging	1b	12	Numeric
*040	Other Medical Type 1	1c	28	Alphanumeric or "STMbnn"
+041	Other Medical Amount 1	1c	12	Numeric
042	Other Medical Type 2	1c	28	Alphanumeric
043	Other Medical Amount 2	1c	12	Numeric
050	Total Other Medical	1c	12	Numeric
060	Total 1a thru 1c	2	12	Numeric
070	7.5% of AGI	3	12	Numeric
080	Total Medical/Dental	4	12	Numeric
090	State & Local Taxes	5	12	Numeric
100	Real Estate Taxes	6	12	Numeric
*130	**Other Taxes Type**	7	28	Alphanumeric or "STMbnn"
+135	**Other Taxes Amount**	7	12	Numeric
140	**Total Other Taxes Amount**	7	12	Numeric
150	**Total Taxes**	8	12	Numeric
155	Form 8598 Indicator		1	"X" or blank
160	Mortgage Interest to Financial Institutions	9a	12	Numeric
@165	Form 1098 Name and Address	9a	6	"STMbnn" or blank
*170	Individual Mortgage Name	9b	20	Alphanumeric or "STMbnn"
+180	Individual Mortgage Address	9b	40	Alphanumeric
+190	Indiv Mortgage Interest Amount	9b	12	Numeric
195	Total Indiv Mortgage Interest Amount	9b	12	Numeric
203	Deductible Points	10	12	Numeric
207	Investment Interest	11	12	Numeric
215	Total Personal Interest	12a	12	Numeric
225	65% of Personal Interest	12b	12	Numeric
290	Total Interest	13	12	Numeric
300	Cash Contributions	14a	12	Numeric
*310	Cash $3000 or More Organization Name 1	14b	35	Alphanumeric or "STMbnn"
+320	Cash $3000 or More Amount 1	14b	12	Numeric
350	Total Cash $3000 or More	14b	12	Numeric
360	Non-Cash Contrib	15	12	Numeric
370	Carryover Prior Yr	16	12	Numeric
380	Total Contributions	17	12	Numeric
390	Casualty/Theft Loss	18	12	NO ENTRY
395	Moving Expenses	19	12	Numeric
405	Unreimbursed Employee Business Expense	20	12	Numeric
*420	Other Expenses Type	21	30	Alphanumeric or "STMbnn"
+430	Other Expenses Amount	21	12	Numeric

Field No.	Identification	Form Ref.	Length	Field Description
435	Total Other Expenses	21	12	Numeric
445	Total Misc Expenses Subject to 2% Limit	22	12	Numeric
455	2% of AGI	23	12	Numeric
465	Line 22 Minus Line 23	24	12	Numeric
*475	Misc Expense Not Subject to 2% Limit Type	25	30	Alphanumeric or "STMbnn"
+485	Misc Expense Not Subject to 2% Limit Amount	25	12	Numeric
495	Total Misc Expenses Not Subject to 2% Limit	25	12	Numeric
520	Total Deductions	26	12	Numeric

Sec. 4 Schedule B

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"1474" for fixed; "0000" for variable format
000	Record ID		26	Value "SCHbBbbbbbnb PG0lbnnnnnnnnn" (n = P-SSN)
*010	Seller Financed Mortgage Name	1	25	Alphanumeric or "STMbnn"
+015	Seller Financed Mortgage Amount	1	12	Numeric
025	Total Seller Financed Mortgage Amount	1	12	Numeric
*030	Interest Payer 1	2	50	Alphanumeric or "STMbnn"
+040	Interest Amount 1	2	12	Numeric
050	Interest Payer 2	2	50	Alphanumeric
060	Interest Amount 2	2	12	Numeric
070	Interest Payer 3	2	50	Alphanumeric
080	Interest Amount 3	2	12	Numeric
090	Interest Payer 4	2	50	Alphanumeric
100	Interest Amount 4	2	12	Numeric
110	Interest Payer 5	2	50	Alphanumeric
120	Interest Amount 5	2	12	Numeric
130	Interest Payer 6	2	50	Alphanumeric
140	Interest Amount 6	2	12	Numeric
150	Interest Payer 7	2	50	Alphanumeric
155	Interest Amount 7	2	12	Numeric
160	Interest Payer 8	2	50	Alphanumeric
170	Interest Amount 8	2	12	Numeric
220	Interest Subtotal	2	12	Numeric
230	Nominee Literal	2	20	"NOMINEEbDISTRIBUTION" or blank
240	Nominee Amount	2	12	Numeric
250	Accrued Interest Literal	2	16	"ACCRUEDbINTEREST" or blank
260	Accrued Interest Amount	2	12	Numeric
270	Tax-Exempt Literal	2	19	"TAX-EXEMPTbINTEREST" or blank
280	Tax Exempt Amount	2	12	Numeric
285	OID Adjustment Literal	2	14	"OID ADJUSTMENT"
287	OID Amount	2	12	Numeric
290	Taxable Interest	3	12	Numeric
*300	Dividend Payer 1	4	50	Alphanumeric or "STMbnn"
+310	Dividend Amount 1	4	12	Numeric
320	Dividend Payer 2	4	50	Alphanumeric
330	Dividend Amount 2	4	12	Numeric
340	Dividend Payer 3	4	50	Alphanumeric
350	Dividend Amount 3	4	12	Numeric
360	Dividend Payer 4	4	50	Alphanumeric
370	Dividend Amount 4	4	12	Numeric
380	Dividend Payer 5	4	50	Alphanumeric
390	Dividend Amount 5	4	12	Numeric
400	Dividend Payer 6	4	50	Alphanumeric
410	Dividend Amount 6	4	12	Numeric
420	Dividend Payer 7	4	50	Alphanumeric
430	Dividend Amount 7	4	12	Numeric
440	Dividend Payer 8	4	50	Alphanumeric
450	Dividend Amount 8	4	12	Numeric
460	Dividend Payer 9	4	50	Alphanumeric
470	Dividend Amount 9	4	12	Numeric
480	Dividend Payer 10	4	50	Alphanumeric
490	Dividend Amount 10	4	12	Numeric
500	Dividend Subtotal	4	12	Numeric
510	Nominee Literal	4	20	"NOMINEEbDISTRIBUTION" or blank
520	Nominee Amount	4	12	Numeric

Field No.	Identification	Form Ref.	Length	Field Description
530	Total Dividends	5	12	Numeric
540	Capital Gains	6	12	Numeric
550	Nontaxable Distribution	7	12	Numeric
570	Total Nontaxable Dividends	8	12	Numeric
580	Taxable Dividends	9	12	Numeric
590	Foreign Account Question—Yes	10	1	"X" or Blank
595	Foreign Account Question—No	10	1	"X" or Blank
600	Foreign Country	10	30	Alphanumeric
610	Foreign Trust Question—Yes	11	1	"X" or Blank
615	Foreign Trust Question—No	11	1	"X" or Blank

Sec. 5 Schedule C, Page 1

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"0897" for fixed; "nnnn" for variable format
000	Record ID		26	Value "SCHbCbbbbbnb PG01bnnnnnnnnn" (n = P-SSN)
010	Name of Proprietor		35	Alpha
015	SSN of Proprietor		9	Numeric
020	Principal Business	A	20	Alphanumeric
030	Business Code	B	4	Numeric
040	Business Name	C	45	Alphanumeric
050	Business Address	C	65	Alphanumeric
060	Employer ID Number	D	9	Numeric
070	Clos Inv Cost Method	E(1)	1	"X" or Blank
080	Lower Cost/Market	E(2)	1	"X" or Blank
090	Other Clos Inv Method	E(3)	1	"X" or Blank
@100	Other Meth Explanation	E(3)	6	"STMbnn" or Blank
110	Cash Acctg Method	F(1)	1	"X" or Blank
120	Accrual Acctg Meth	F(2)	1	"X" or Blank
130	Other Acctg Method	F(3)	1	"X" or Blank
*140	Type of Other Meth	F(3)	25	Alphanumeric or "STMbnn"
150	Change Inventory Question—Yes	G	1	"X" or Blank
@153	Change Inventory Method Explanation	G	6	"STMbnn" or Blank
157	Change Inventory Question—No	G	1	"X" or Blank
163	Home Office Expense Deduction—Yes	H	1	"X" or Blank
167	Home Office Expense Deduction—No	H	1	"X" or Blank
173	Form 941 Filed—Yes	I	1	"X" or Blank
175	Form 941 Filed—No	I	1	"X" or Blank
177	Materially Participate in 1987—Yes	J	1	"X" or Blank
183	Materially Participate in 1987—No	J	1	"X" or Blank
185	In Operation at End of 1987—Yes	K	1	"X" or Blank
187	In Operation at End of 1987—No	K	1	"X" or Blank
193	Number of Months in Operation in 1987	L	2	"00-12"
195	Tax Shelter Registration Requirement	M	1	NO ENTRY
200	Gross Receipts/Sales	1a	12	Numeric
210	Returns/Allowances	1b	12	Numeric
220	Line 1a minus Line 1b	1c	12	Numeric
230	Cost of Goods Sold and/or Operations	2	12	Numeric
240	Gross Profit	3	12	Numeric
260	Other Income	4	12	Numeric
270	Gross Income	5	12	Numeric
280	Advertising Expense	6	12	Numeric
283	Bad Debts	7	12	Numeric
287	Bank Service Charges	8	12	Numeric
293	Car/Truck Expenses	9	12	Numeric
297	Commissions	10	12	Numeric
303	Depletion	11	12	Numeric
307	Depreciation/Sec 179 Deduction	12	12	Numeric
313	Dues/Publications	13	12	Numeric
317	Employee Benefit Prog	14	12	Numeric
323	Freight	15	12	Numeric
327	Insurance	16	12	Numeric

Field No.	*Identification*	*Form Ref.*	*Length*	*Field Description*
@333	Form 1098 Name/Address	17	6	"STMbnn" or Blank
337	Mortgage Interest	17a	12	Numeric
343	Other Interest	17b	12	Numeric
347	Laundry/Cleaning	18	12	Numeric
353	Legal/Prof Services	19	12	Numeric
357	Office Expense	20	12	Numeric
363	Pension/Profit Sharing	21	12	Numeric
367	Rent on Property	22	12	Numeric
373	Repairs	23	12	Numeric
377	Supplies	24	12	Numeric
383	Taxes	25	12	Numeric
387	Travel	26a	12	Numeric
393	Meals/Entertainment	26b	12	Numeric
397	20% of Line 26b Subject to Limitations	26c	12	Numeric
403	Line 26b Minus Line 26c	26d	12	Numeric
407	Utilities/Telephone	27	12	Numeric
410	Wages	28a	12	Numeric
430	Jobs Credit	28b	12	NO ENTRY
450	Wages less Jobs Credit	28c	12	Numeric
*500	Other Expense Type 1		25	Alphanumeric or "STMbnn"
+510	Other Expense Amount 1		12	Numeric
530	Other Expense Type 2		25	Alphanumeric
540	Other Expense Amount 2		12	Numeric
560	Other Expense Type 3		25	Alphanumeric
570	Other Expense Amount 3		12	Numeric
580	Other Expense Type 4		25	Alphanumeric
590	Other Expense Amount 4		12	Numeric
605	Total Other Expenses	29	12	Numeric
700	Total Deductions	30	12	Numeric
710	Net Profit (Loss)	31	12	Numeric
720	Amounts Not At Risk Yes 32		1	"X" or Blank
730	Amounts Not At Risk No	32	1	"X" or Blank

Sec. 6 Schedule C, Page 2

	Byte Count		4	"0126" for fixed; "nnnn" for variable format
735	Record ID		26	Value "SCHbCbbbbbnb PG02bnnnnnnnnn" (n = P-SSN)
740	Beginning Inventory	PIII 1	12	Numeric
750	Purchases	PIII 2	12	Numeric
760	Cost of Labor	PIII 3	12	Numeric
770	Materials/Supplies	PIII 4	12	Numeric
780	Other Costs	PIII 5	12	Numeric
790	Total Lines 1—5	PIII 6	12	Numeric
800	End of Year Inventory	PIII 7	12	Numeric
810	Cost of Goods Sold	PIII 8	12	Numeric

Sec. 7 Schedule D, Page 1

	Byte Count		4	"2088" for fixed; "nnnn" for variable format
000	Record ID		26	Value "SCHbDbbbbbnb PG01bnnnnnnnnn" (n = P-SSN)
010	Total F1099-B Sales	1	12	Numeric
@015	F1099-B Explanation of Difference	1	6	"STMbnn" or Blank
*020	Short F1099-B Desc 1	2a(a)1	15	Alphanumeric or "STMbnn"
+030	Date Acquired 1	2a(b)1	6	MMDDYY
+040	Date Sold 1	2a(c)1	6	MMDDYY
+050	Sales Price 1	2a(d)1	12	Numeric
060	Cost/Other Basis 1	2a(e)1	12	Numeric
+070	Loss Property 1	2a(f)1	12	Numeric
+080	Gain Property 1	2a(g)1	12	Numeric
090	Short F1099-B Desc 2	2a(a)2	15	Alphanumeric
100	Date Acquired 2	2a(b)2	6	MMDDYY
110	Date Sold 2	2a(c)2	6	MMDDYY
120	Sales Price 2	2a(d)2	12	Numeric
130	Cost/Other Basis 2	2a(e)2	12	Numeric
140	Loss Property 2	2a(f)2	12	Numeric
150	Gain Property 2	2a(g)2	12	Numeric
160	Short F1099-B Desc 3	2a(a)3	15	Alphanumeric
170	Date Acquired 3	2a(b)3	6	MMDDYY
180	Date Sold 3	2a(c)3	6	MMDDYY
190	Sales Price 3	2a(d)3	12	Numeric
200	Cost/Other Basis 3	2a(e)3	12	Numeric
210	Loss Property 3	2a(f)3	12	Numeric
220	Gain Property 3	2a(g)3	12	Numeric

Field No.	Identification	Form Ref.	Length	Field Description
230	Short F1099-B Desc 4	2a(a)4	15	Alphanumeric
240	Date Acquired 4	2a(b)4	6	MMDDYY
250	Date Sold 4	2a(c)4	6	MMDDYY
260	Sales Price 4	2a(d)4	12	Numeric
270	Cost/Other Basis 4	2a(e)4	12	Numeric
280	Loss Property 4	2a(f)4	12	Numeric
290	Gain Property 4	2a(g)4	12	Numeric
300	Short F1099-B Desc 5	2a(a)5	15	Alphanumeric
310	Date Acquired 5	2a(b)5	6	MMDDYY
320	Date Sold 5	2a(c)5	6	MMDDYY
330	Sales Price 5	2a(d)5	12	Numeric
340	Cost/Other Basis 5	2a(e)5	12	Numeric
350	Loss Property 5	2a(f)5	12	Numeric
360	Gain Property 5	2a(g)5	12	Numeric
370	Short F1099-B Desc 6	2a(a)6	15	Alphanumeric
380	Date Acquired 6	2a(b)6	6	MMDDYY
390	Date Sold 6	2a(c)6	6	MMDDYY
400	Sales Price 6	2a(d)6	12	Numeric
410	Cost/Other Basis 6	2a(e)6	12	Numeric
420	Loss Property 6	2a(f)6	12	Numeric
430	Gain Property 6	2a(g)6	12	Numeric
440	Short F1099-B Desc 7	2a(a)7	15	Alphanumeric
450	Date Acquired 7	2a(b)7	6	MMDDYY
460	Date Sold 7	2a(c)7	6	MMDDYY
470	Sales Price 7	2a(d)7	12	Numeric
480	Cost/Other Basis 7	2a(e)7	12	Numeric
490	Loss Property 7	2a(f)7	12	Numeric
500	Gain Property 7	2a(g)7	12	Numeric
510	Short F1099-B Desc 8	2a(a)8	15	Alphanumeric
520	Date Acquired 8	2a(b)8	6	MMDDYY
530	Date Sold 8	2a(c)8	6	MMDDYY
540	Sales Price 8	2a(d)8	12	Numeric
550	Cost/Other Basis 8	2a(e)8	12	Numeric
560	Loss Property 8	2a(f)8	12	Numeric
570	Gain Property 8	2a(g)8	12	Numeric
580	Short F1099-B Desc 9	2a(a)9	15	Alphanumeric
590	Date Acquired 9	2a(b)9	6	MMDDYY
600	Date Sold 9	2a(c)9	6	MMDDYY
610	Sales Price 9	2a(d)9	12	Numeric
620	Cost/Other Basis 9	2a(e)9	12	Numeric
630	Loss Property 9	2a(f)9	12	Numeric
640	Gain Property 9	2a(g)9	12	Numeric
645	Total F1099-B Sales Price Short Term	2b(d)	12	Numeric
*650	Other Short Desc 1	2c(a)1	15	Alphanumeric or "STMbnn"
+660	Date Acquired 1	2c(b)1	6	MMDDYY
+670	Date Sold 1	2c(c)1	6	MMDDYY
+680	Sales Price 1	2c(d)1	12	Numeric
+690	Cost/Other Basis 1	2c(e)1	12	Numeric
+700	Loss Property 1	2c(f)1	12	Numeric
+710	Gain Property 1	2c(g)1	12	Numeric
720	Other Short Desc 2	2c(a)2	15	Alphanumeric
725	Date Acquired 2	2c(b)2	6	MMDDYY
730	Date Sold 2	2c(c)2	6	MMDDYY
735	Sales Price 2	2c(d)2	12	Numeric
740	Cost/Other Basis 2	2c(e)2	12	Numeric
745	Loss Property 2	2c(f)2	12	Numeric
750	Gain Property 2	2c(g)2	12	Numeric
755	Other Short Desc 3	2c(a)3	15	Alphanumeric
760	Date Acquired 3	2c(b)3	6	MMDDYY
765	Date Sold 3	2c(c)3	6	MMDDYY
770	Sales Price 3	2c(d)3	12	Numeric
775	Cost/Other Basis 3	2c(e)3	12	Numeric
780	Loss Property 3	2c(f)3	12	Numeric
785	Gain Property 3	2c(g)3	12	Numeric
790	Residence Short Gain	3(g)	12	Numeric
800	Installment Sale Gain	4(g)	12	Numeric
810	Net Short Term Loss (Part/S-Corp/Fiduc)	5(f)	12	Numeric
820	Net Short Term Gain (Part/S-Corp/Fiduc)	5(g)	12	Numeric
860	Short Loss Carryover	6(f)	12	Numeric
863	Total Short Term Column (f) Losses	7(f)	12	Numeric
867	Total Short Term Column (g) Gains	7(g)	12	Numeric
870	Net Short Gain/Loss	8(g)	12	Numeric
*880	Long F1099-B Desc 1	9a(a)1	15	Alphanumeric or "STMbnn"
+890	Date Acquired Prop 1	9a(b)1	6	MMDDYY
+900	Dete Sold Prop 1	9a(c)1	6	MMDDYY
+910	Sales Price 1	9a(d)1	12	Numeric

Field No.	Identification	Form Ref.	Length	Field Description
+920	Cost/Other Basis 1	9a(e)1	12	Numeric
+930	Long F1099-B Loss 1	9a(f)1	12	Numeric
+940	Long F1099-B Gain 1	9a(g)1	12	Numeric
950	Long F1099-B Desc 2	9a(a)2	15	Alphanumeric
960	Date Acquired Prop 2	9a(b)2	6	MMDDYY
970	Date Sold Prop 2	9a(c)2	6	MMDDYY
980	Sales Price 2	9a(d)2	12	Numeric
990	Cost/Other Basis 2	9a(e)2	12	Numeric
1000	Long F1099-B Loss 2	9a(f)2	12	Numeric
1010	Long F1099-B Gain 2	9a(g)2	12	Numeric
1020	Long F1099-B Desc 3	9a(a)3	15	Alphanumeric
1030	Date Acquired Prop 3	9a(b)3	6	MMDDYY
1040	Date Sold Prop 3	9a(c)3	6	MMDDYY
1050	Sales Price 3	9a(d)3	12	Numeric
1060	Cost/Other Basis 3	9a(e)3	12	Numeric
1070	Long F1099-B Loss 3	9a(f)3	12	Numeric
1080	Long F1099-B Gain 3	9a(g)3	12	Numeric
1090	Long F1099-B Desc 4	9a(a)4	15	Alphanumeric
1100	Date Acquired Prop 4	9a(b)4	6	MMDDYY
1110	Date Sold Prop 4	9a(c)4	6	MMDDYY
1120	Sales Price 4	9a(d)4	12	Numeric
1130	Cost/Other Basis 4	9a(e)4	12	Numeric
1140	Long F1099-B Loss 4	9a(f)4	12	Numeric
1150	Long F1099-B Gain 4	9a(g)4	12	Numeric
1160	Long F1099-B Desc 5	9a(a)5	15	Alphanumeric
1170	Date Acquired Prop 5	9a(b)5	6	MMDDYY
1180	Date Sold Prop 5	9a(c)5	6	MMDDYY
1190	Sales Price 5	9a(d)5	12	Numeric
1200	Cost/Other Basis 5	9a(e)5	12	Numeric
1210	Long F1099-B Loss 5	9a(f)5	12	Numeric
1220	Long F1099-B Gain 5	9a(g)5	12	Numeric
1230	Long F1099-B Desc 6	9a(a)6	15	Alphanumeric
1240	Date Acquired Prop 6	9a(b)6	6	MMDDYY
1250	Date Sold Prop 6	9a(c)6	6	MMDDYY
1260	Sales Price 6	9a(d)6	12	Numeric
1270	Cost/Other Basis 6	9a(e)6	12	Numeric
1280	Long F1099-B Loss 6	9a(f)6	12	Numeric
1290	Long F1099-B Gain 6	9a(g)6	12	Numeric
1300	Long F1099-B Desc 7	9a(a)7	15	Alphanumeric
1310	Date Acquired Prop 7	9a(b)7	6	MMDDYY
1320	Date Sold Prop 7	9a(c)7	6	MMDDYY
1330	Sales Price 7	9a(d)7	12	Numeric
1340	Cost/Other Basis 7	9a(e)7	12	Numeric
1350	Long F1099-B Loss 7	9a(f)7	12	Numeric
1360	Long F1099-B Gain 7	9a(g)7	12	Numeric
1370	Long F1099-B Desc 8	9a(a)8	15	Alphanumeric
1380	Date Acquired Prop 8	9a(b)8	6	MMDDYY
1390	Date Sold Prop 8	9a(c)8	6	MMDDYY
1400	Sales Price 8	9a(d)8	12	Numeric
1410	Cost/Other Basis 8	9a(e)8	12	Numeric
1420	Long F1099-B Loss 8	9a(f)8	12	Numeric
1430	Long F1099-B Gain 8	9a(g)8	12	Numeric
1440	Long F1099-B Desc 9	9a(a)9	15	Alphanumeric
1450	Date Acquired Prop 9	9a(b)9	6	MMDDYY
1460	Date Sold Prop 9	9a(c)9	6	MMDDYY
1470	Sales Price 9	9a(d)9	12	Numeric
1480	Cost/Other Basis 9	9a(e)9	12	Numeric
1490	Long F1099-B Loss 9	9a(f)9	12	Numeric
1500	Long F1099-B Gain 9	9a(g)9	12	Numeric
1505	Total F1099-B Sales Price Long Term	9b(d)	12	Numeric
*1510	Long Other Desc 1	9c(a)1	15	Alphanumeric or "STMbnn"
+1520	Date Acquired Other 1	9c(b)1	6	MMDDYY
+1530	Date Sold Other 1	9c(c)1	6	MMDDYY
+1540	Sales Price Other 1	9c(d)1	12	Numeric

Field No.	Identification	Form Ref.	Length	Field Description
+1550	Cost/Other Basis 1	9c(e)1	12	Numeric
+1560	Long Other Loss 1	9c(f)1	12	Numeric
+1570	Long Other Gain 1	9c(g)1	12	Numeric
1580	Long Other Desc 2	9c(a)2	15	Alphanumeric
1590	Date Acquired Other 2	9c(b)2	6	MMDDYY
1600	Date Sold Other 2	9c(c)2	6	MMDDYY
1610	Sales Price Other 2	9c(d)2	12	Numeric
1620	Cost/Other Basis 2	9c(e)2	12	Numeric
1630	Long Other Loss 2	9c(f)2	12	Numeric
1640	Long Other Gain 2	9c(g)2	12	Numeric
1650	Long Other Desc 3	9c(a)3	15	Alphanumeric
1660	Date Acquired Other 3	9c(b)3	6	MMDDYY
1670	Date Sold Other 3	9c(c)3	6	MMDDYY
1680	Sales Price Other 3	9c(d)3	12	Numeric
1690	Cost/Other Basis 3	9c(e)3	12	Numeric
1700	Long Other Loss 3	9c(f)3	12	Numeric
1710	Long Other Gain 3	9c(g)3	12	Numeric
1720	Residence Long Term	10(g)	12	Numeric Gain
1730	Installment Sales Long Term Gain	11(g)	12	Numeric
1740	Net Long Term Loss (Part/S-Corp/Fiduc)	12(f)	12	Numeric
1750	Net Long Term Gain (Part/S-Corp/Fiduc)	12(g)	12	Numeric
1790	Capital Gain Distrib	13(g)	12	Numeric
1800	Gain From Form 4797	14(g)	12	NO ENTRY
1820	Long Term Loss Carryover	15(f)	12	Numeric
1823	Total Long Term Column (f) Losses	16(f)	12	Numeric
1827	Total Long Term Column (g) Gains	16(g)	12	Numeric
1830	Net Long Term Gain/Loss	17	12	Numeric

Sec. 8 Schedule D, Page 2

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"0442" for fixed; "nnnn" for variable format
1840	Record ID		26	Value "SCHbDbbbbbnb PG02bnnnnnnnnn" (n = P-SSN)
1850	Line 8 plus Line 17	18	12	Numeric
1865	Smaller of Line 18 Loss or Maximum	19	12	Numeric
1873	Taxable Income Form 1040, Line 36	20	12	Numeric
1877	Smaller of Line 18 Gain or Line 17 Gain	21	12	Numeric
1883	Line 20 Minus Line 21	22	12	Numeric
1887	Filing Status Limit	23	12	Numeric
1893	Greater of Line 22 or Line 23	24	12	Numeric
1897	Line 20 Minus Line 24	25	12	Numeric
1903	Tax on Line 24	26	12	Numeric
1905	Line 25 Times .28	27	12	Numeric
1907	Line 26 Plus Line 27	28	12	Numeric
1910	Line 8 Loss Amount	29	12	Numeric
1920	Line 17 Gain Amount	30	12	Numeric
1930	Line 29 Minus Line 30	31	12	Numeric
1940	Smaller Line 19 or 31	32	12	Numeric
1950	Line 31 Minus Line 32	33	12	Numeric
1970	Line 17 Loss	34	12	Numeric
1980	Line 8 Gain	35	12	Numeric
1990	Line 34 Minus Line 35	36	12	Numeric
2005	Line 19 Minus Line 32	37	12	Numeric
2010	Line 36 Minus Line 37	38	12	Numeric
2020	Election Out of Installment Method	39	1	"X" or Blank
2030	Face Amount of Note	40	12	Numeric
2040	Valuation Percentage	41	5	Numeric
2110	Form 1040, Line 21	42	12	Numeric
2120	Sch C Bartering Income	43	12	Numeric
2130	Sch D Bartering Income	44	12	Numeric
2140	Sch E Bartering Income	45	12	Numeric
2150	Sch F Bartering Income	46	12	NO ENTRY

Field No.	Identification	Form Ref.	Length	Field Description
*2155	Other Bartering Income Description	47	40	Alphanumeric or "STMbnn"
+2160	Other Bartering Income	47	12	Numeric Amount
2165	Total Other Bartering Income	47	12	Numeric
@2170	Non-Taxable Explanation	47	6	"STMbnn" or Blank
2180	Total Bartering Income	48	12	Numeric

Sec.9 Schedule E, Page 1

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"1303" for fixed; "nnnn" for variable format
000	Record ID		26	"SCHbEbbbbbnb PG01bnnnnnnnnn" (n = P-SSN)
010	Property Kind	A-1	20	Alphanumeric
020	Property Address	A-1	37	Alphanumeric
030	Personal Use—Yes	A-2	1	"X" or blank
035	Personal Use—No	A-2	1	"X" or blank
037	Actively Participate—Yes	A-3	1	"X" or blank
039	Actively Participate—No	A-3	1	"X" or blank
040	Property Kind	B-1	20	Alphanumeric
050	Property Address	B-1	37	Alphanumeric
060	Personal Use—Yes	B-2	1	"X" or blank
065	Personal Use—No	B-2	1	"X" or blank
067	Actively Participate—Yes	B-3	1	"X" or blank
069	Actively Participate—No	B-3	1	"X" or blank
070	Property Kind	C-1	20	Alphanumeric
080	Property Address	C-1	37	Alphanumeric
090	Personal Use—Yes	C-2	1	"X" or blank
095	Personal Use—No	C-2	1	"X" or blank
097	Actively Participate—Yes	C-3	1	"X" or blank
099	Actively Participate—No	C-3	1	"X" or blank
100	Rents Received A	A-4	12	Numeric
110	Rents Received B	B-4	12	Numeric
120	Rents Received C	C-4	12	Numeric
125	Total Rents Received	4	12	Numeric
130	Royalties Received A	A-5	12	Numeric
140	Royalties Received B	B-5	12	Numeric
150	Royalties Received C	C-5	12	Numeric
155	Total Royalties Rec'd	5	12	Numeric
170	Advertising A	A-6	12	Numeric
180	Advertising B	B-6	12	Numeric
190	Advertising C	C-6	12	Numeric
200	Auto-Travel A	A-7	12	Numeric
210	Auto-Travel B	B-7	12	Numeric
220	Auto-Travel C	C-7	12	Numeric
230	Cleaning-Maint A	A-8	12	Numeric
240	Cleaning-Maint B	B-8	12	Numeric
250	Cleaning-Maint C	C-8	12	Numeric
260	Commissions A	A-9	12	Numeric
270	Commissions B	B-9	12	Numeric
280	Commissions C	C-9	12	Numeric
290	Insurance A	A-10	12	Numeric
300	Insurance B	B-10	12	Numeric
310	Insurance C	C-10	12	Numeric
320	Legal-Pro Fees A	A-11	12	Numeric
330	Legal-Pro Fees B	B-11	12	Numeric
340	Legal-Pro Fees C	C-11	12	Numeric
350	Mortgage Interest A	A-12	12	Numeric
360	Mortgage Interest B	B-12	12	Numeric
370	Mortgage Interest C	C-12	12	Numeric
380	Total Mort Interest	12	12	Numeric
@385	Form 1098 Name/ Address	12	6	"STMbnn" or blank
390	Other Interest A	A-13	12	Numeric
400	Other Interest B	B-13	12	Numeric
410	Other Interest C	C-13	12	Numeric
420	Repairs A	A-14	12	Numeric
430	Repairs B	B-14	12	Numeric
440	Repairs C	C-14	12	Numeric
450	Supplies A	A-15	12	Numeric
460	Supplies B	B-15	12	Numeric
470	Supplies C	C-15	12	Numeric
480	Taxes A	A-16	12	Numeric
490	Taxes B	B-16	12	Numeric
500	Taxes C	C-16	12	Numeric
510	Utilities A	A-17	12	Numeric
520	Utilities B	B-17	12	Numeric
530	Utilities C	C-17	12	Numeric
540	Wages-Salaries A	A-18	12	Numeric
550	Wages-Salaries B	B-18	12	Numeric
560	Wages-Salaries C	C-18	12	Numeric

Field No.	Identification	Form Ref.	Length	Field Description
*570	Other-Description 1	A-19-1	25	Alphanumeric or "STMbnn"
+580	Other Amount A	A-19-1	12	Numeric
+590	Other Amount B	B-19-1	12	Numeric
+600	Other Amount C	C-19-1	12	Numeric
610	Other-Description 2	A-19-2	25	Alphanumeric
620	Other Amount A	A-19-2	12	Numeric
630	Other Amount B	B-19-2	12	Numeric
640	Other Amount C	C-19-2	12	Numeric
650	Other-Description 3	A-19-3	25	Alphanumeric
660	Other Amount A	A-19-3	12	Numeric
670	Other Amount B	B-19-3	12	Numeric
680	Other Amount C	C-19-3	12	Numeric
690	Other-Description 4	A-19-4	25	Alphanumeric
700	Other Amount A	A-19-4	12	Numeric
710	Other Amount B	B-19-4	12	Numeric
720	Other Amount C	C-19-4	12	Numeric
970	Tot Expenses Less Deprec A	A-20	12	Numeric
980	Tot Expenses Less Deprec B	B-20	12	Numeric
990	Tot Expenses Less Deprec C	C-20	12	Numeric
1000	Tot Expenses Less Deprec	20	12	Numeric
1010	Deprec Expense A	A-21	12	Numeric
1020	Deprec Expense B	B-21	12	Numeric
1030	Deprec Expense C	C-21	12	Numeric
1040	Total Depreciation	21	12	Numeric
1050	Total Expenses A	A-22	12	Numeric
1060	Total Expenses B	B-22	12	Numeric
1070	Total Expenses C	C-22	12	Numeric
1080	Net Rental Income (Loss) A	A-23	12	Numeric
1090	Net Rental Income (Loss) B	B-23	12	Numeric
1100	Net Rental Income (Loss) C	C-23	12	Numeric
1103	Deductible Rental Loss A	A-24	12	Numeric
1105	Deductible Rental Loss B	B-24	12	Numeric
1107	Deductible Rental Loss C	C-24	12	Numeric
1110	Total Profits	25	12	Numeric
1120	Total Losses	26	12	Numeric
1130	Net Profit (Loss)	27	12	Numeric
1140	Net Farm Rental Profit-Loss	28	12	NO ENTRY
1150	Total Income or Loss	29	12	Numeric

Sec. 10 Schedule E, Page 2

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"1343" for fixed; "nnnn" for variable format
1160	Record ID		26	"SCHbEbbbbnb PG02bnnnnnnnnn" (n = P-SSN)
*1170	Part/S-Corp Name A	A(a)	47	Alphanumeric or "STMbnn"
+1172	Part/S-Corp Ind	A(b)	1	"P" or "S"
+1174	Foreign Partner	A(c)	1	"X" = Yes, " " = No
+1176	Part/S-Corp EIN	A(d)	9	Alphanumeric
+1178	Not At Risk—Yes	A(e)	1	"X" or Blank
+1180	Not At Risk—No	A(e)	1	"X" or Blank
+*1186	Part/S-Corp Passive F8582 Loss	A(f)	12	Numeric or "STMbnn"
+1188	Part/S-Corp Passive Sch K-1 Income	A(g)	12	Numeric
+1192	Part/S-Corp Non-passive Sch K-1 Loss	A(h)	12	Numeric
+1194	Part/S-Corp Non-passive Sec 179 Deduction	A(i)	12	Numeric
+1196	Part/S-Corp Non-passive Sch K-1 Income	A(j)	12	Numeric
1200	Part/S-Corp Name B	B(a)	47	Alphanumeric
1210	Part/S-Corp Ind	B(b)	1	"P" or "S"
1220	Foreign Partner	B(c)	1	"X" = Yes, " " = No
1230	Part/S-Corp EIN	B(d)	9	Alphanumeric
1236	Not At Risk—Yes	B(e)	1	"X" or Blank
1238	Not At Risk—No	B(e)	1	"X" or Blank
1243	Part/S-Corp Passive F8582 Loss	B(f)	12	Numeric
1247	Part/S-Corp Passive Sch K-1 Income	B(g)	12	Numeric
1253	Part/S-Corp Non-passive Sch K-1 Loss	B(h)	12	Numeric
1255	Part/S-Corp Non-passive Sec 179 Deduction	B(i)	12	Numeric
1257	Part/S-Corp Non-passive Sch K-1 Income	B(j)	12	Numeric
1260	Part/S-Corp Name C	C(a)	47	Alphanumeric

Field No.	*Identification*	*Form Ref.*	*Length*	*Field Description*
1270	Part/S-Corp Ind	C(b)	1	"P" or "S"
1280	Foreign Partner	C(c)	1	"X" = Yes, " " = No
1290	Part/S-Corp EIN	C(d)	9	Alphanumeric
1296	Not At Risk—Yes	C(e)	1	"X" or Blank
1298	Not At Risk—No	C(e)	1	"X" or Blank
1303	Part/S-Corp Passive F8582 Loss	C(f)	12	Numeric
1307	Part/S-Corp Passive Sch K-1 Income	C(g)	12	Numeric
1313	Part/S-Corp Nonpassive Sch K-1 Loss	C(h)	12	Numeric
1315	Part/S-Corp Nonpassive Sec 179 Deduction	C(i)	12	Numeric
1317	Part/S-Corp Nonpassive Sch K-1 Income	C(j)	12	Numeric
1320	Part/S-Corp Name D	D(a)	47	Alphanumeric
1330	Part/S-Corp Ind	D(b)	1	"P" or "S"
1340	Foreign Partner	D(c)	1	"X" = Yes, " " = No
1350	Part/S-Corp EIN	D(d)	9	Alphanumeric
1356	Not At Risk—Yes	D(e)	1	"X" or Blank
1358	Not At Risk—No	D(e)	1	"X" or Blank
1363	Part/S-Corp Passive F8582 Loss	D(f)	12	Numeric
1367	Part/S-Corp Passive Sch K-1 Income	D(g)	12	Numeric
1373	Part/S-Corp Nonpassive Sch K-1 Loss	D(h)	12	Numeric
1375	Part/S-Corp Nonpassive Sec 179 Deduction	D(i)	12	Numeric
1377	Part/S-Corp Nonpassive Sch K-1 Income	D(j)	12	Numeric
1380	Part/S-Corp Name E	E(a)	47	Alphanumeric
1390	Part/S-Corp Ind	E(b)	1	"P" or "S"
1400	Foreign Partner	E(c)	1	"X" = Yes, " " = No
1410	Part/S-Corp EIN	E(d)	9	Alphanumeric
1416	Not At Risk—Yes	E(e)	1	"X" or Blank
1418	Not At Risk—No	E(e)	1	"X" or Blank
1423	Part/S-Corp Passive F8582 Loss	E(f)	12	Numeric
1427	Part/S-Corp Passive Sch K-1 Income	E(g)	12	Numeric
1433	Part/S-Corp Nonpassive Sch K-1 Loss	E(h)	12	Numeric
1435	Part/S-Corp Nonpassive Sec 179 Deduction	E(i)	12	Numeric
1437	Part/S-Corp Nonpassive Sch K-1 Income	E(j)	12	Numeric
1445	Total Part/S-Corp Sch K-1 Passive Inc	30a(g)	12	Numeric
1455	Total Part/S-Corp Sch K-1 Nonpassive Inc	30a(j)	12	Numeric
1475	Total Passive F8582 Loss	30b(f)	12	Numeric
1485	Total Nonpassive Sch K-1 Loss	30b(h)	12	Numeric
1495	Total Nonpassive Sec 179 Deduction	30b(i)	12	Numeric
1750	Tot Part/S-Corp Income	31	12	Numeric
1755	Tot Part/S-Corp Loss and Sec 179 Deduction	32	12	Numeric
1765	Net Part/S-Corp Income or Loss	33	12	Numeric
*1790	Estate/Trust Name A	A(a)	65	Alphanumeric or "STMbnn"
+1800	Estate/Trust EIN	A(b)	9	Alphanumeric
+*1807	Passive F8582 Loss	A(c)	12	Numeric or "STMbnn"
+1813	Passive Sch K-1 Income	A(d)	12	Numeric
+1817	Nonpassive Sch K-1 Loss A(e)		12	Numeric
+1825	Nonpassive Sch K-1 Inc	A(f)	12	Numeric
1830	Estate/Trust Name B	B(a)	65	Alphanumeric
1840	Estate/Trust EIN	B(b)	9	Alphanumeric
1847	Passive F8582 Loss	B(c)	12	Numeric
1853	Passive Sch K-1 Income	B(d)	12	Numeric
1857	Nonpassive Sch K-1 Loss B(e)		12	Numeric
1865	Nonpassive Sch K-1 Inc	B(f)	12	Numeric
1870	Estate/Trust Name C	C(a)	65	Alphanumeric
1880	Estate/Trust EIN	C(b)	9	Alphanumeric
1887	Passive F8582 Loss	C(c)	12	Numeric

Field No.	*Identification*	*Form Ref.*	*Length*	*Field Description*
1893	Passive Sch K-1 Income	C(d)	12	Numeric
1897	Nonpassive Sch K-1 Loss C(e)	12		Numeric
1905	Nonpassive Sch K-1 Inc	C(f)	12	Numeric
1913	Total Passive Sch K-1 Income	34a(d)	12	Numeric
1917	Total Nonpassive Sch K-1 Income	34a(f)	12	Numeric
1923	Total Passive F8582 Loss	34b(c)	12	Numeric
1927	Total Nonpassive Sch K-1 Loss	34b(e)	12	Numeric
1933	Tot Estate/Trust Inc	35	12	Numeric
1937	Tot Estate/Trust Loss	36	12	Numeric
1939	Sch K-1 ES Payments Literal	37	18	"ESbPAYMENTb-CLAIMED" or blank
1943	Sch K-1 ES Payments Amount	37	12	Numeric
1945	Total Estate/Trust Net Income/Loss	37	12	Numeric
*1953	REMIC Name	38(a)	20	Alphanumeric or "STMbnn"
+1957	REMIC EIN	38(b)	9	Alphanumeric
+1963	Excess Inclusion	38(c)	12	Numeric
+1967	Sch Q Taxable Income/Net Loss	38(d)	12	Numeric
+1973	Sch Q Line 3 Income	38(e)	12	Numeric
1977	Total REMIC Income	38	12	Numeric
1980	Windfall Profit Credit Rec 1987	39	12	Numeric
1990	Windfall Profit Withheld in 1987	40	12	Numeric
2000	Total Windfall Profit Credit	41	12	Numeric
2010	Total Supplemental Income (Loss)	42	12	Numeric
2020	Farming/Fishing Share	43	12	Numeric

Sec. 11 Schedule R, Page 1

Field No.	*Identification*	*Form Ref.*	*Length*	*Field Description*
	Byte Count		4	"0042" for fixed; "nnnn" for variable format
000	Record ID		26	Value "SCHbRbbbbbnb PGO1bnnnnnnnnn" (n = P-SSN)
010	Over 65	1	1	"X" or Blank
020	Retire/Disabled	2	1	"X" or Blank
030	Both Over 65	3	1	"X" or Blank
040	Both Under 65, One Retired	4	1	"X" or Blank
050	Both Under 65, Both Retired	5	1	"X" or Blank
060	One Over 65, Other Retired	6	1	"X" or Blank
070	One Over 65, Other Not Retired	7	1	"X" or Blank
080	Over 65, Did Not Live With Spouse	8	1	"X" or Blank
090	Under 65, Did Not Live With Spouse	9	1	"X" or Blank
100	Prior Year Statement Indicator	II-2	1	"X" or Blank
110	At Least One Year	II-A	1	"X" or Blank
120	Permanent Disability	II-B	1	"X" or Blank

Sec. 12 Schedule R, Page 2

Field No.	*Identification*	*Form Ref.*	*Length*	*Field Description*
	Byte Count		4	"0186" for fixed; "nnnn" for variable format
130	Record ID		26	Value "SCHbRbbbbbnb PG02bnnnnnnnnn" (n = P-SSN)
140	Write Amount	10	12	Numeric
150	Taxable Disability	11	12	Numeric
160	Smaller of Line 10 or 11	12	12	Numeric Amount
163	Nontaxable SSB	13a	12	Numeric
167	Nontaxable RRB/Other	13b	12	Numeric
170	Pensions & Annuities	13c	12	Numeric
180	Amount 1040, Line 31	14	12	Numeric
190	Write 7500, 10000, or 5000	15	12	Numeric
200	Line 14 Minus Line 15	16	12	Numeric
210	Line 16 Divided by 2	17	12	Numeric
220	Line 13c Plus Line 17	18	12	Numeric
230	Line 12 Minus Line 18	19	12	Numeric
250	Credit	21	12	Numeric

Sec. 13 Schedule SE

	Byte Count		4	"0279" for fixed; "nnnn" for variable format
000	Record ID		26	Value "SCHbSEbbbbnb PG01bnnnnnnnnn" (n = P-SSN)
010	Name of Self-Employed		35	Alpha
020	SSN of Self-Employed		9	Numeric
025	Exempt/Form 4361 Box		1	"X" or Blank
030	Net Farm Profit/Loss	1	12	Numeric
040	Net Non-Farm Prof/Loss	2	12	Numeric
060	Farm Optional Meth Amt	4	12	Numeric
070	Line 3 Minus Line 4	5	12	Numeric
080	Non-Farm Opt Meth Amt	6	12	Numeric
090	Line 1 or Line 4 Amt	7	12	Numeric
100	Line 2 or Line 6 Amt	8	12	Numeric
110	Sum of Lines 7 and 8	9	12	Numeric
120	SST Wages/RRT Comp	11a	12	Numeric
130	Unreported Tips	11b	12	Numeric
140	Line 11a Plus Line 11b	11c	12	Numeric
150	Line 10 Minus Line 11c	12a	12	Numeric
160	Qualified US Govt Wages	12b	12	Numeric
170	W-2 Wages from Churches	12c	12	Numeric
175	Line 12c or Sum of Lines 9 and 12c	12d	12	Numeric
185	Smaller Line 12a or 12d	13	12	Numeric
190	Self-Employment Tax	14	12	Numeric

Sec. 14 Form W-2

(This form does not contain all fields from the printed form but only the selected items shown.)

Field No.	*Identification*	*Form Ref.*	*Length*	*Field Description*
	Byte Count		4	"0120" for fixed; "nnnn" for variable format
010	Record ID		26	Value "FRMbW-2bbbnn PG01bnnnnnnnnn" (n = P-SSN from F1040)
020	Employer Name	2	35	Alphanumeric or blank
030	Employer Identification Number	3	9	Numeric
040	SSN	8	9	Numeric (W-2 Social Security Number)
050	Withholding	9	12	Numeric
060	Wages	10	12	Numeric
070	Social Security Tax	11	12	Numeric
090	Fringe Benefit Ind		1	"X" or blank

Sec. 15 Form W-2G

(This form does not contain all fields from the printed form but only the selected items shown.)

	Byte Count		4	"0107" for fixed; "nnnn" for variable format
010	Record ID		26	Value "FRMbW-2Gbbnn PGO1bnnnnnnnnn" (n = P-SSN from F1040)
020	Payer Name		35	Alphanumeric or blank
030	Payer Identification Number		9	Numeric
040	Gross Winnings, etc.	1	12	Numeric
050	Withholding	2	12	Numeric
060	SSN	9	9	Numeric (W-2G Social Security Number)

Sec. 16 Form W-2P

(This form does not contain all fields from the printed form but only the selected items shown.)

	Byte Count		4	"0120" for fixed; "nnnn" for variable format
010	Record ID		26	Value "FRMbW-2Pbbnn PGO1bnnnnnnnnn" (n = P-SSN from F1040)
020	Payer Name	2	35	Alphanumeric or blank
030	Payer Identification Number	3	9	Numeric
040	SSN	8	9	Numeric (W-2P Social Security Number)
050	Annuity, Pension, etc.	9	12	Numeric
060	Taxable Amount	10	12	Numeric
070	Withholding	11	12	Numeric
080	Disability Indicator		1	"X" or blank

Sec. 17 Form 2106, Page 1

	Byte Count		4	"0364" for fixed; "nnnn" for variable format
000	Record ID		26	Value "FRMb2106bbnn PGO1bnnnnnnnnn" (n = P-SSN)

Field No.	Identification	Form Ref.	Length	Field Description
003	SSN of Taxpayer With Employee Business Expense		9	Numeric
005	Occupation		25	Alphanumeric
010	Vehicle Expenses	1	12	Numeric
013	Parking, Tolls, Local Transporation	2	12	Numeric
017	Travel Expenses Away From Home Excluding Meals/Entertainment	3	12	Numeric
023	Other Business Expenses Excluding Meals/Entertainment	4	12	Numeric
025	Meals/Entertainment Expenses	5	12	Numeric
027	Total Expenses Excluding Meals/Entertainment	6A	12	Numeric
031	Total Meals/Entertainment	6B	12	Numeric
033	Other Reimbursements Not Reported on W-2/F1099	7A	12	Numeric
041	Meals/Entertainment Reimbursements Not Reported on W-2/F1099	7B	12	Numeric
043	Col A, Line 7 Minus Line 6	8A	12	Numeric
045	Col B, Line 7 Minus Line 6	8B	12	Numeric
049	Excess Reimbursements	9	12	Numeric
055	Col A, Line 6 Minus Line 9	10A	12	Numeric
059	Col B, Line 6 Minus Line 9	10B	12	Numeric
061	Col A, Reimbursements Reported on W-2/F1099	11A	12	Numeric
065	Col B, Reimbursements Reported on W-2/F1099	11B	12	Numeric
069	Col A, Smaller of Line 10 or Line 11	12A	12	Numeric
071	Col B, Smaller of Line 10 or Line 11	12B	12	Numeric
079	Sum of Line 12, Col A and Line 12, Col B	13	12	Numeric
081	Line 10 Minus Line 12, Col A	14A	12	Numeric
085	Line 10 Minus Line 12, Col B	14B	12	Numeric
089	20% of Line 14, Col B	15	12	Numeric
091	Line 14 Minus Line 15, Col A	16A	12	Numeric
095	Line 14 Minus Line 15, Col B	16B	12	Numeric
125	Total Line 16, Col A and Line 16, Col B	17	12	Numeric

Sec. 18 Form 2106, Page 2

	Byte Count		4	"0479" for fixed; "nnnn" for variable format
127	Record ID		26	Value "FRMb2106bbnn PG02bnnnnnnnnn" (n = P-SSN)
130	Vehicle Date (1)	1(1)	6	MMDDYY
135	Total Miles (1)	2(1)	6	Numeric
145	Business Miles (1)	3(1)	6	Numeric
155	Percent of Use (1)	4(1)	5	Numeric
165	Average Distance (1)	5(1)	6	Numeric
175	Miles Commuting (1)	6(1)	6	Numeric
185	Other Mileage (1)	7(1)	6	Numeric
195	Vehicle Date (2)	1(2)	6	MMDDYY
205	Total Miles (2)	2(2)	6	Numeric
215	Business Miles (2)	3(2)	6	Numeric
225	Percent of Use (2)	4(2)	5	Numeric
235	Average Distance (2)	5(2)	6	Numeric
245	Miles Commuting (2)	6(2)	6	Numeric
255	Other Mileage (2)	7(2)	6	Numeric
270	Another Vehicle Yes	8	1	"X" or blank
275	Another Vehicle No	8	1	"X" or blank
280	Personal Use Yes	9	1	"X" or blank
283	Personal Use No	9	1	"X" or blank
285	Personal Use Not Applicable	9	1	"X" or blank
290	Evidence Yes	10	1	"X" or blank
295	Evidence No	10	1	"X" or blank
300	Written Yes	10	1	"X" or blank
305	Written No	10	1	"X" or blank
310	Smaller Line 3 or Limit	11	6	Numeric
320	Line 3 Minus Line 11	12	6	Numeric

Field No.	*Identification*	*Form Ref.*	*Length*	*Field Description*
330	Line 11 X .225	13	12	Numeric
340	Line 12 X .11	14	12	Numeric
350	Line 13 Plus Line 14	15	12	Numeric
360	Gas, Oil (1)	16(1)	12	Numeric
365	Rentals (1)	17(1)	12	Numeric
375	Value (1)	18(1)	12	Numeric
385	Add Lines 16–18 (1)	19(1)	12	Numeric
395	Line 19 X Line 4 Percent (1)	20(1)	12	Numeric
405	Depreciation (1)	21(1)	12	Numeric
415	Line 20 + Line 21 (1)	22(1)	12	Numeric
425	Gas, Oil (2)	16(2)	12	Numeric
435	Rentals (2)	17(2)	12	Numeric
445	Value (2)	18(2)	12	Numeric
455	Add Lines 16–18 (2)	19(2)	12	Numeric
465	Line 19 X Line 4 Percent (2)	20(2)	12	Numeric
475	Depreciation (2)	21(2)	12	Numeric
485	Line 20 + Line 21 (2)	22(2)	12	Numeric
500	Vehicle 1 Basis	(a)	12	Numeric
510	Vehicle 1 Recovery	(b)	12	Numeric
520	Vehicle 1 Method	(c)	11	Alphanumeric
530	Vehicle 1 Depreciation	(d)	12	Numeric
540	Vehicle 1 179	(e)	12	Numeric
550	Vehicle 1 Total	(f)	12	Numeric
560	Vehicle 2 Basis	(a)	12	Numeric
570	Vehicle 2 Recovery	(b)	12	Numeric
580	Vehicle 2 Method	(c)	11	Alphanumeric
590	Vehicle 2 Depreciation	(d)	12	Numeric
600	Vehicle 2 179	(e)	12	Numeric
610	Vehicle 2 Total	(f)	12	Numeric

Sec. 19 Form 2119

Field No.	*Identification*	*Form Ref.*	*Length*	*Field Description*
	Byte Count		4	"0236" for fixed; "nnnn" for variable format
000	Record ID		26	Value "FRMb2119bbnn PG01bnnnnnnnnn" (n = P-SSN)
010	Date Residence Sold	1a	6	MMDDYY
020	Face Amount of Note	1b	12	Numeric
030	Date Resid Occupied	2a	6	MMDDYY, "NONE" or Blank
040	Partial Bus Use Yes	2b	1	"X" or Blank
050	Partial Bus Use No	2b	1	"X" or Blank
060	Self 55 or Over Yes	3a	1	"X" or Blank
070	Self 55 or Over No	3a	1	"X" or Blank
080	Spouse 55 or Over Yes	3b	1	"X" or Blank
090	Spouse 55 or Over No	3b	1	"X" or Blank
100	Principal Residence Yes	3c	1	"X" or Blank
110	Principal Residence No	3c	1	"X" or Blank
120	Lifetime Exclusion Yes	3d	1	"X" or Blank
130	Lifetime Exclusion No	3d	1	"X" or Blank
140	Owner Residence You	3e	1	"X" or Blank
150	Owner Residence Spouse	3e	1	"X" or Blank
160	Owner Residence Both	3e	1	"X" or Blank
170	Different Spouse SSN	3f	9	Numeric, "NONE" or Blank
180	Selling Price	4	12	Numeric
183	Expense of Sale	5	12	Numeric
187	Amount Realized	6	12	Numeric
190	Basis Residence Sold	7	12	Numeric
200	Gain on Sale	8	12	Numeric
210	Replace Residence Yes		1	"X" or Blank
220	Replace Residence No		1	"X" or Blank
230	Exclusion Amount	9	12	Numeric
240	Gain After Exclusion	10	12	Numeric
250	Fixing-Up Expenses	11	12	Numeric
260	Adjusted Sales Price	12	12	Numeric
270	Cost of New Residence	13	12	Numeric
280	Gain Taxable This Year	14	12	Numeric
290	Gain to be Postponed	15	12	Numeric
300	Adjusted Basis	16	12	Numeric
310	Spouse Consent Indicator		2	"SC" or Blank

Sec. 20 Form 2441

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"0133" for fixed; "nnnn" for variable format
000	Record ID		26	Value "FRMb2441bbnn PG01bnnnnnnnnn" (n = P-SSN)
010	Number of Qualifying Persons	1	2	Numeric
040	Expenses	2	12	Numeric
050	Earned Income	3a	12	Numeric
060	Spouses Income	3b	12	Numeric
070	Smaller Income	3c	12	Numeric
080	Smaller of Line 2 or Line 3a or 3c	4	12	Numeric
090	Applicable Percentage	5	5	Numeric
100	Line 4 Times Line 5	6	12	Numeric
110	Last Year Carryover	7	12	Numeric
120	Line 6 Plus Line 7	8	12	Numeric

Sec. 21 Form 3903

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"0364" for fixed; "nnnn" for variable format
000	Record ID		26	Value "FRMb3903bbnn PG01bnnnnnnnnn" (n = P-SSN)
010	Miles Old Residence to New Work Place	1	6	Numeric
020	Miles Old Residence to Old Work Place	2	6	Numeric
030	Mileage Difference	3	6	Numeric
040	Transport Goods Exp	4	12	Numeric
042	Traveling Lodging/Travel	5	12	Numeric
044	Traveling Meals	6	12	Numeric
046	Traveling Meals Reimbursement	7	12	Numeric
048	Line 6 Minus Line 7	8	12	Numeric
052	Line 8 Times .80	9	12	Numeric
054	Sum of Lines 5, 7 & 9	10	12	Numeric
056	Premove Travel/Lodging	11	12	Numeric
058	Meals Househunting	12	12	Numeric
062	Househunting Meals Reimbursement	13	12	Numeric
064	Line 12 Minus Line 13	14	12	Numeric
066	Line 14 Times .80	15	12	Numeric
068	Sum of Lines Lines 11, 13 and 15	16	12	Numeric
073	Temporary Lodging Exp	17	12	Numeric
077	Meals Temp Quarters	18	12	Numeric
083	Temp Quarters Meals Reimbursement	19	12	Numeric
087	Line 18 Minus Line 19	20	12	Numeric
093	Line 20 Times .80	21	12	Numeric
097	Sum of Lines 17, 19 and 21	22	12	Numeric
100	Sold/Exchanged Res	23a	1	"X" or Blank
110	Settled Lease	23b	1	"X" or Blank
120	Sell/Settle Lease Exp	23	12	Numeric
130	Buying New Residence	24a	1	"X" or Blank
140	Obtaining Lease	24b	1	"X" or blank
150	Expense to Buy/Lease	24	12	Numeric
163	Sum of Lines 16 and 22	25	12	Numeric
167	Smaller of Line 25 or Limit	26	12	Numeric
173	Sum of Lines 23, 24 and 26	27	12	Numeric
177	Smaller of Line 27 or Limit	28	12	Numeric
180	Moving Exp Deduction	29	12	Numeric

Sec. 22 Form 4562, Page 1

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"0768" for fixed; "nnnn" for variable format
000	Record ID		26	Value "FRMb4562bbnn PG01bnnnnnnnnn" (n = P-SSN)
010	Activity		30	Alphanumeric
*020	Class of Property 1	1(a)-1	20	Alphanumeric or "STMbNN"
+025	Date in Service 1	1(b)-1	6	MMDDYY
+030	Cost 1	1(c)-1	12	Numeric
+040	Expense Deduction 1	1(d)-1	12	Numeric
050	Class of Property 2	1(a)-2	20	Alphanumeric
055	Date in Service 2	1(b)-2	6	MMDDYY
060	Cost 2	1(c)-2	12	Numeric

Field No.	*Identification*	*Form Ref.*	*Length*	*Field Description*
070	Expense Deduction 2	1(d)-2	12	Numeric
080	Listed Property	2	12	Numeric
083	Sum of Lines 1 and 2	3	12	Numeric
087	Cost Over $200,000	4	12	Numeric
090	Total Sec 179 Deduction	5	12	Numeric
*100	3-Year Cost	6a(c)	12	Numeric or "STMbnn"
+110	3-Year Recovery	6a(d)	2	Numeric
+120	3-Yr Method Figuring	6a(e)	5	Alphanumeric
+130	3-Year Deduction	6a(f)	12	Numeric
*140	5-Year Cost	6b(c)	12	Numeric or "STMbnn"
+150	5-Year Recovery	6b(d)	2	Numeric
+160	5-Yr Method Figuring	6b(e)	5	Alphanumeric
+170	5-Year Deduction	6b(f)	12	Numeric
*172	7-Year Cost	6c(c)	12	Numeric or "STMbnn"
+174	7-Year Recovery	6c(d)	2	Numeric
+176	7-Yr Method Figuring	6c(e)	5	Alphanumeric
+178	7-Year Deduction	6c(f)	12	Numeric
*180	10-Year Cost	6d(c)	12	Numeric or "STMbnn"
+190	10-Year Recovery	6d(d)	2	Numeric
+200	10-Yr Method Figuring	6d(e)	5	Alphanumeric
+210	10-Year Deduction	6d(f)	12	Numeric
*220	15-Yr Cost	6e(c)	12	Numeric or "STMbnn"
+230	15-yr Recovery	6e(d)	2	Numeric
+240	15-Yr Method	6e(e)	5	Alphanumeric
+250	15-Year Deduction	6e(f)	12	Numeric
*275	20-Yr Cost	6f(c)	12	Numeric or "STMbnn"
+285	20-yr Recovery	6f(d)	2	Numeric
+295	20-Yr Method	6f(e)	5	Alphanumeric
+305	20-Year Deduction	6f(f)	12	Numeric
*313	Residential Rental Prop Date in Service 1	6g(b)1	6	MMDDYY or "STMbnn"
+317	Residential Rental Prop Cost 1	6g(c)1	12	Numeric
+323	Residential Rental Prop Recovery 1	6g(d)1	3	Numeric
+327	Residential Rental Prop Method 1	6g(e)1	5	Alphanumeric
+333	Residential Rental Prop Deduction 1	6g(f)1	12	Numeric
337	Residential Rental Prop Date in Service 2	6g(b)2	6	MMDDYY
343	Residential Rental Prop Cost 2	6g(c)2	12	Numeric
347	Residential Rental Prop Recovery 2	6g(d)2	3	Numeric
353	Residential Rental Prop Method 2	6g(e)2	5	Alphanumeric
357	Residentail Rental Prop Deduction 2	6g(f)2	12	Numeric
*363	Nonresidential Real Prop Date in Service 1	6h(b)1	6	MMDDYY or "STMbnn"
+367	Nonresidential Real Prop Cost 1	6h(c)1	12	Numeric
+373	Nonresidential Real Prop Recovery 1	6h(d)1	3	Numeric
+377	Nonresidential Real Prop Method 1	6h(e)1	5	Alphanumeric
+383	Nonresidential Real Prop Deduction 1	6h(f)1	12	Numeric
387	Nonresidential Real Prop Date in Service 2	6h(b)2	6	MMDDYY
393	Nonresidential Real Prop Cost 2	6h(c)2	12	Numeric
397	Nonresidential Real Prop Recovery 2	6h(d)2	3	Numeric
403	Nonresidential Real Prop Method 2	6h(e)2	5	Alphanumeric
407	Nonresidential Real Prop Deduction 2	6h(f)2	12	Numeric
460	Listed Property	7	12	Numeric
470	ACRS Deduction	8	12	Numeric
@475	Line 9 Explanation		6	"STMbnn" or blank
480	Prop Subject to Sect 168(f)(1) Election	9	12	Numeric
490	Other Depreciation	10	12	Numeric
500	Total Depreciation	11	12	Numeric
505	Sec 263A Current Year Cost	12	12	Numeric
*510	Descrip of Prop 1	II-1(a)1	20	Alphanumeric or "STMbnn"
+520	Date Acquired 1	II-1(b)1	6	MMDDYY
+530	Cost 1	II-1(c)1	12	Numeric
+540	Code Section 1	II-1(d)1	5	Alphanumeric

Field No.	Identification	Form Ref.	Length	Field Description
+550	Amortization Period or Percentage 1	II-1(e)1	5	Alphanumeric
+560	Amortization 1	II-1(f)1	12	Numeric
570	Descrip of Prop 2	II-1(a)2	20	Alphanumeric
580	Date Acquired 2	II-1(b)2	6	MMDDYY
590	Cost 2	II-1(c)2	12	Numeric
600	Code Section 2	II-1(d)2	5	Alphanumeric
610	Amortization Period or Percentage 2	II-1(e)2	5	Alphanumeric
620	Amortization 2	II-1(f)2	12	Numeric
685	Amortization Pre-1987 Property	II-2(f)	12	Numeric
750	Total Amortization	II-3(f)	12	Numeric

Sec. 23 Form 4562, Page 2

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"0998" for fixed; "nnnn" for variable format
760	Record ID		26	Value "FRMb4562bbnn PG02bnnnnnnnnn" (n = P-SSN)
762	Evidence—Yes		1	"X" or blank
764	Evidence—No		1	"X" or blank
766	Written—Yes		1	"X" or blank
768	Written—No		1	"X" or blank
*770	Description 1	III(a)1	12	Alphanumeric or "STMbnn"
+780	Date Service 1	III(b)1	6	MMDDYY
+790	Percent Use 1	III(c)1	5	Numeric
+800	Cost or Basis 1	III(d)1	12	Numeric
+810	Deprec Basis 1	III(e)1	12	Numeric
+820	Method/Recov Per 1	III(f)1	9	Alphanumeric
+830	Deprec Deduction 1	III(g)1	12	Numeric
+840	179 Expense 1	III(h)1	12	Numeric
850	Description 2	III(a)2	12	Alphanumeric
860	Date Service 2	III(b)2	6	MMDDYY
870	Percent Use 2	III(c)2	5	Numeric
880	Cost or Basis 2	III(d)2	12	Numeric
890	Deprec Basis 2	III(e)2	12	Numeric
900	Method/Recov Per 2	III(f)2	9	Alphanumeric
910	Deprec Deduction 2	III(g)2	12	Numeric
920	179 Expense 2	III(h)2	12	Numeric
930	Description 3	III(a)3	12	Alphanumeric
940	Date Service 3	III(b)3	6	MMDDYY
950	Percent Use 3	III(c)3	5	Numeric
960	Cost or Basis 3	III(d)3	12	Numeric
970	Deprec Basis 3	III(e)3	12	Numeric
980	Method/Recov Per 3	III(f)3	9	Alphanumeric
990	Deprec Deduction 3	III(g)3	12	Numeric
1000	179 Expense 3	III(h)3	12	Numeric
1010	Description 4	III(a)4	12	Alphanumeric
1020	Date Service 4	III(b)4	6	MMDDYY
1030	Percent Use 4	III(c)4	5	Numeric
1040	Cost or Basis 4	III(d)4	12	Numeric
1050	Deprec Basis 4	III(e)4	12	Numeric
1060	Method/Recov Per 4	III(f)4	9	Alphanumeric
1070	Deprec Deduction 4	III(g)4	12	Numeric
1080	179 Expense 4	III(h)4	12	Numeric
1090	Description 5	III(a)5	12	Alphanumeric
1100	Date Service 5	III(b)5	6	MMDDYY
1110	Percent Use 5	III(c)5	5	Numeric
1120	Cost or Basis 5	III(d)5	12	Numeric
1130	Deprec Basis 5	III(e)5	12	Numeric
1140	Method/Recov Per 5	III(f)5	9	Alphanumeric
1150	Deprec Deduction 5	III(g)5	12	Numeric
1160	179 Expense 5	III(h)5	12	Numeric
1170	Description 6	III(a)6	12	Alphanumeric
1180	Date Service 6	III(b)6	6	MMDDYY
1190	Percent Use 6	III(c)6	5	Numeric
1200	Cost or Basis 6	III(d)6	12	Numeric
1210	Deprec Basis 6	III(e)6	12	Numeric
1220	Method/Recov Per 6	III(f)6	9	Alphanumeric
1230	Deprec Deduction 6	III(g)6	12	Numeric
1240	179 Expense 6	III(h)6	12	Numeric
1250	Description 7	III(a)7	12	Alphanumeric
1260	Date Service 7	III(b)7	6	MMDDYY
1270	Percent Use 7	III(c)7	5	Numeric
1280	Cost or Basis 7	III(d)7	12	Numeric
1290	Deprec Basis 7	III(e)7	12	Numeric
1300	Method/Recov Per 7	III(f)7	9	Alphanumeric
1310	Deprec Deduction 7	III(g)7	12	Numeric
1320	179 Expense 7	III(h)7	12	Numeric
1330	Description 8	III(a)8	12	Alphanumeric
1340	Date Service 8	III(b)8	6	MMDDYY

Field No.	Identification	Form Ref.	Length	Field Description
1350	Percent Use 8	III(c)8	5	Numeric
1360	Cost or Basis 8	III(d)8	12	Numeric
1370	Deprec Basis 8	III(e)8	12	Numeric
1380	Method/Recov Per 8	III(f)8	9	Alphanumeric
1390	Deprec Deduction 8	III(g)8	12	Numeric
1400	179 Expense 8	III(h)8	12	Numeric
1410	Description 9	III(a)9	12	Alphanumeric
1420	Date Service 9	III(b)9	6	MMDDYY
1430	Percent Use 9	III(c)9	5	Numeric
1440	Cost or Basis 9	III(d)9	12	Numeric
1450	Deprec Basis 9	III(e)9	12	Numeric
1460	Method/Recov Per 9	III(f)9	9	Alphanumeric
1470	Deprec Deduction 9	III(g)9	12	Numeric
1480	179 Expense 9	III(h)9	12	Numeric
1490	Total 179 Expense	III(h)	12	Numeric
1500	Total Depreciation Deduction	III(g)	12	Numeric
*1610	Total Miles 1	IIIB1–1	6	Numeric or "STMbnn"
+1620	Business Miles 1	IIIB2–1	6	Numeric
+1630	Commuting Miles 1	IIIB3–1	6	Numeric
+1640	Other Personal Miles	IIIB4–1	6	Numeric
1650	Total Miles 2	IIIB1–2	6	Numeric
1660	Business Miles 2	IIIB2–2	6	Numeric
1670	Commuting Miles 2	IIIB3–2	6	Numeric
1680	Other Personal Miles	IIIB4–2	6	Numeric
1690	Total Miles 3	IIIB1–3	6	Numeric
1700	Business Miles 3	IIIB2–3	6	Numeric
1710	Commuting Miles 3	IIIB3–3	6	Numeric
1720	Other Personal Miles	IIIB4–3	6	Numeric
1730	Total Miles 4	IIIB1–4	6	Numeric
1740	Business Miles 4	IIIB2–4	6	Numeric
1750	Commuting Miles 4	IIIB3–4	6	Numeric
1760	Other Personal Miles	IIIB4–4	6	Numeric
1770	Total Miles 5	IIIB1–5	6	Numeric
1780	Business Miles 5	IIIB2–5	6	Numeric
1790	Commuting Miles 5	IIIB3–5	6	Numeric
1800	Other Personal Miles	IIIB4–5	6	Numeric
1810	Total Miles 6	IIIB1–6	6	Numeric
1820	Business Miles 6	IIIB2–6	6	Numeric
1830	Commuting Miles 6	IIIB3–6	6	Numeric
1840	Other Personal Miles	IIIB4–6	6	Numeric
*1850	Vehicle Available Yes	IIIB5–1	6	"Xbbbbb", "STMbnn" or Blank
+1860	Vehicle Available No	IIIB5–1	1	"X" or Blank
+1863	Primary Use by Over 5% Owner/Relative Yes	IIIB6–1	1	"X" or Blank
+1867	Primary Use by Over 5% Owner/Relative No	IIIB6–1	1	"X" or Blank
+1870	Another Vehicle Yes	IIIB7–1	1	"X" or Blank
+1880	Another Vehicle No	IIIB7–1	1	"X" or Blank
1910	Vehicle Available Yes	IIIB5–2	6	"Xbbbbb" or Blank
1920	Vehicle Available No	IIIB5–2	1	"X" or Blank
1923	Primary Use by Over 5% Owner/Relative Yes	IIIB6–2	1	"X" or Blank
1927	Primary Use by Over 5% Owner/Relative No	IIIB6–2	1	"X" or Blank
1930	Another Vehicle Yes	IIIB7–2	1	"X" or Blank
1940	Another Vehicle No	IIIB7–2	1	"X" or Blank
1970	Vehicle Available Yes	IIIB5–3	6	"Xbbbbb" or Blank
1980	Vehicle Available No	IIIB5–3	1	"X" or Blank
1983	Primary Use by Over 5% Owner/Relative Yes	IIIB6–3	1	"X" or Blank
1987	Primary Use by Over 5% Owner/Relative No	IIIB6–3	1	"X" or Blank
1990	Another Vehicle Yes	IIIB7–3	1	"X" or Blank
2000	Another Vehicle No	IIIB7–3	1	"X" or Blank
2030	Vehicle Available Yes	IIIB5–4	6	"Xbbbbb" or Blank
2040	Vehicle Available No	IIIB5–4	1	"X" or Blank

Field No.	Identification	Form Ref.	Length	Field Description
2043	Primary Use by Over 5% Owner/ Relative Yes	IIIB6–4	1	"X" or Blank
2047	Primary Use by Over 5% Owner/ Relative No	IIIB6–4	1	"X" or Blank
2050	Another Vehicle Yes	IIIB7–4	1	"X" or Blank
2060	Another Vehicle No	IIIB7–4	1	"X" or Blank
2090	Vehicle Available Yes	IIIB5–5	6	"Xbbbbb" or Blank
2100	Vehicle Available No	IIIB5–5	1	"X" or Blank
2103	Primary Use by Over 5% Owner/ Relative Yes	IIIB6–5	1	"X" or Blank
2107	Primary Use by Over 5% Owner/ Relative No	IIIB6–5	1	"X" or Blank
2110	Another Vehicle Yes	IIIB7–5	1	"X" or Blank
2120	Another Vehicle No	IIIB7–5	1	"X" or Blank
2150	Vehicle Available Yes	IIIB5–6	6	"Xbbbbb" or Blank
2160	Vehicle Available No	IIIB5–6	1	"X" or Blank
2163	Primary Use by Over 5% Owner/ Relative Yes	IIIB6–6	1	"X" or Blank
2167	Primary Use by Over 5% Owner/ Relative No	IIIB6–6	1	"X" or Blank
2170	Another Vehicle Yes	IIIB7–6	1	"X" or Blank
2180	Another Vehicle No	IIIB7–6	1	"X" or Blank
2190	Maintain Statement Yes	IIIC8	1	"X" or Blank
2200	Maintain Statement No	IIIC8	1	"X" or Blank
2210	Maintain Statement Yes	IIIC9	1	"X" or Blank
2220	Maintain Statement No	IIIC9	1	"X" or Blank
2230	All Personal Use Yes	IIIC10	1	"X" or Blank
2240	All Personal Use No	IIIC10	1	"X" or Blank
2250	More Than 5 Yes	IIIC11	1	"X" or Blank
2260	More Than 5 No	IIIC11	1	"X" or Blank
2270	Meet Requirements Yes	IIIC12	1	"X" or Blank
2280	Meet Requirements No	IIIC12	1	"X" or Blank

Sec. 24 Form 6198

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"0448" for fixed; "nnnn" for variable format
000	Record ID		26	Value "FRMb6198bbnn PG01bnnnnnnnnn" (n = P-SSN)
005	Description of Activity		80	Alphanumeric
010	Activity Profit/Loss	1	12	Numeric
020	Sch D Gain/Loss	2a	12	Numeric
030	F4797 Gain/Loss	2b	12	Numeric
*033	Other Gain/Loss Type		20	Alphanumeric or "STMbnn"
+037	Other Gain/Loss Amount		12	Numeric
040	Total Other Gain/ Loss	2c	12	Numeric
050	Sch K-1 Income/ Gain/Loss	3	12	Numeric
060	Other Deductions	4	12	Numeric
070	Overall Profit/Loss	5	12	Numeric
080	Adjusted Basis	6	12	Numeric
090	Tax Year Increases	7	12	Numeric
100	Line 6 Plus Line 7	8	12	Numeric
110	Tax Year Decreases	9	12	Numeric
120	Line 8 Minus Line 9	10	12	Numeric
130	Amount at Risk	10	12	Numeric
140	Investment	11	12	Numeric
150	Increases at Effective Date	12	12	Numeric
160	Line 11 Plus Line 12	13	12	Numeric
170	Decreases at Effective Date	14	12	Numeric
180	At Risk Effective Date Box	15a	1	"X" or Blank
190	1986 F6198, Line 19 Box	15b	1	"X" or Blank
200	Amount at Risk	15	12	Numeric
210	Increases Effective Date Box	16a	1	"X" or Blank
220	Increases End of 1986 Box	16b	1	"X" or Blank
230	Amount of Increases	16	12	Numeric
240	Line 15 Plus Line 16	17	12	Numeric
250	Decreases Effective Date Box	18a	1	"X" or Blank

Field No.	*Identification*	*Form Ref.*	*Length*	*Field Description*
260	Decreases End of 1986 Box	18b	1	"X" or Blank
270	Amount of Decreases	18	12	Numeric
280	Line 17 Minus Line 18	19	12	Numeric
290	Amount at Risk	19	12	Numeric
300	Larger of Line 10 or Line 19	20	12	Numeric
310	Deductible Loss	21	12	Numeric

Sec. 25 Form 6251

Field No.	*Identification*	*Form Ref.*	*Length*	*Field Description*
	Byte Count		4	"0582" for fixed; "nnnn" for variable format
000	Record ID		26	Value "FRMb6251bbnn PG01bnnnnnnnnn" (n = P-SSN)
005	Taxable Income	1	12	Numeric
015	Net Operating Loss	2	12	Numeric
025	Line 1 plus Line 2	3	12	Numeric
035	Standard Deduction	4a	12	Numeric
045	Medical/Dental Expense	4b	12	Numeric
055	Miscellaneous Itemized Deductions	4c	12	Numeric
065	Schedule A Taxes	4d	12	Numeric
075	Schedule A Interest	4e	12	Numeric
085	Other Interest Adjust	4f	12	Numeric
095	Depreciation	4g	12	Numeric
105	Circulation, Research, Experimental Expense	4h	12	Numeric
115	Mining Exploration and Development Costs	4i	12	Numeric
125	Long Term Contracts	4j	12	Numeric
135	Pollution Control Facilities	4k	12	Numeric
145	Certain Installment Sales	4l	12	Numeric
147	Basis Adjustment	4m	12	Numeric
151	Certain Loss Limitations	4n	12	Numeric
155	Tax Shelter Farm Loss	4o	12	Numeric
163	Passive Activity Loss	4p	12	Numeric
165	Beneficiaries of Estates and Trusts	4q	12	Numeric
166	Personal Exemptions	4r	12	Numeric
167	Total Adjustments	4s	12	Numeric
170	Accelerated Depreciation Pre-1987 Real Property	5a	12	Numeric
180	Accel Depreciation Pre-1987 Leased Property	5b	12	Numeric
190	Amortization Pre-1987 Pollution Control Fac	5c	12	Numeric
195	Appreciated Property Charitable Deduction	5d	12	Numeric
205	Incentive Stock Option	5e	12	Numeric
215	Tax Exempt Interest from Private Activity Bond	5f	12	Numeric
225	Intangible Drilling	5g	12	Numeric
230	Depletion	5h	12	Numeric
235	Reserves for Bad Debts	5i	12	Numeric
260	Total Tax Pref Items	5j	12	Numeric
263	Sum of Lines 3, 4s & 5j	6	12	Numeric
267	Alternative Tax Net Operating Loss	7	12	Numeric
283	Alternative Minimum Taxable Income	8	12	Numeric
287	Line 9 Filing Status Amount	9	12	Numeric
293	Line 10 Filing Status Amount	10	12	Numeric
297	Line 8 Minus Line 10	11	12	Numeric
303	Line 11 Times .25	12	12	Numeric
307	Line 9 Minus Line 12	13	12	Numeric
315	Line 8 Minus Line 13	14	12	Numeric
325	Line 14 Times .21	15	12	Numeric
330	Foreign Tax Credit	16	12	NO ENTRY
333	Tentative Minimum Tax	17	12	Numeric
337	Regular Tax Before Credits Minus Foreign Tax Credit	18	12	Numeric
340	Alternative Minimum Tax	19	12	Numeric

Sec. 26 Form 6252

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"0608" for fixed; "nnnn" for variable format
000	Record ID		26	Value "FRMb6252bbnn PG01bnnnnnnnnn" (n = P-SSN)
010	Property Description	A	65	Alphanumeric
020	Date Acquired	B	6	MMDDYY
030	Date Sold	C	6	MMDDYY
040	Related Party Yes	D	1	"X" or Blank
050	Related Party No	D	1	"X" or Blank
060	Marketable Security Yes	E	1	"X" or Blank
070	Marketable Security No	E	1	"X" or Blank
080	Selling Price	1	12	Numeric
090	Mortgage/ Indebtedness	2	12	Numeric
100	Line 1 Minus Line 2	3	12	Numeric
110	Cost or Basis	4	12	Numeric
120	Depreciation Allowable	5	12	Numeric
130	Adjusted Basis	6	12	Numeric
140	Commission/Other Exp	7	12	Numeric
150	Income Recapture F4797	8	12	NO ENTRY
160	Sum of Lines 6/7/8	9	12	Numeric
170	Line 1 Minus Line 9	10	12	Numeric
180	Form 2119 Amount	11	12	Numeric
190	Gross Profit	12	12	Numeric
200	Line 2 Minus Line 9	13	12	Numeric
210	Contract Price	14	12	Numeric
220	Gross Profit Ratio	15	5	Alphanumeric
230	Yr of Sale Line 13 Amt	16	12	Numeric
240	Payments Received	17	12	Numeric
245	Allocable Installment Indebtedness	18	12	Numeric
250	Sum of Lines 16, 17 and 18	19	12	Numeric
260	Payments Recd Prior Yr	20	12	Numeric
270	Taxable Part	21	12	Numeric
280	Ordinary Income Part	22	12	Numeric
290	Line 21 Minus Line 22	23	12	Numeric
300	Related Party Identity	F	40	Alphanumeric
310	Continuation Data	F	80	Alphanumeric
320	Property Sold Yes	G	1	"X" or Blank
330	Property Sold No	G	1	"X" or Blank
340	1st Disp Sale/ Exchange	H	1	"X" or Blank
350	2nd Disp Involuntary Conversion	H	1	"X" or Blank
360	2nd Disp After Death of Original Purchaser	H	1	"X" or Blank
370	Disposition Not to Avoid Tax	H	1	"X" or Blank
@380	Explanation of Disp Not to Avoid Tax	H	6	"STMbnn" or Blank
390	Selling Price	24	12	Numeric
400	Contract Price 1st Yr	25	12	Numeric
410	Smaller Line 24 or 25	26	12	Numeric
420	Total Payments Received	27	12	Numeric
430	Line 26 Minus Line 27	28	12	Numeric
440	Line 28 Times 1st Year Gross Profit Ratio	29	12	Numeric
450	Line 29 Ordinary Income	30	12	Numeric
460	Line 29 Minus Line 30	31	12	Numeric

Sec. 27 Form 8283, Page 1

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"0891" for fixed; "nnnn" for variable format
000	Record ID		26	Value "FRMb8283bbnn PG01bnnnnnnnnn" (n = P-SSN)
*010	Donee Organization A	A1a	25	Alphanumeric or "STMbnn"
+020	Donee Address A	A1a	25	Alphanumeric
+030	Descrip of Prop A	A1b	25	Alphanumeric
050	Donee Organization B	B1a	25	Alphanumeric
060	Donee Address B	B1a	25	Alphanumeric
070	Descrip of Prop B	B1b	25	Alphanumeric
090	Donee Organization C	C1a	25	Alphanumeric
100	Donee Address C	C1a	25	Alphanumeric
110	Descrip of Prop C	C1b	25	Alphanumeric
130	Donee Organization D	D1a	25	Alphanumeric
140	Donee Address D	D1a	25	Alphanumeric

Field No.	*Identification*	*Form Ref.*	*Length*	*Field Description*
150	Descrip of Prop D	D1b	25	Alphanumeric
170	Donee Organization E	E1a	25	Alphanumeric
180	Donee Address E	E1a	25	Alphanumeric
190	Descrip of Prop E	E1b	25	Alphanumeric
*210	Contribution Date A	Ac	6	MMDDYY or "STMbnn"
+220	Date Acquired A	Ad	4	MMYY
+230	How Acquired A	Ae	11	Alphanumeric
+240	Cost or Basis A	Af	12	Numeric
+250	Fair Market Value A	Ag	12	Numeric
+255	Method Used A	Ah	20	Alphanumeric
260	Contribution Date B	Bc	6	MMDDYY
270	Date Acquired B	Bd	4	MMYY
280	How Acquired B	Be	11	Alphanumeric
290	Cost or Basis B	Bf	12	Numeric
300	Fair Market Value B	Bg	12	Numeric
305	Method Used B	Bh	20	Alphanumeric
310	Contribution Date C	Cc	6	MMDDYY
320	Date Acquired C	Cd	4	MMYY
330	How Acquired C	Ce	11	Alphanumeric
340	Cost or Basis C	Cf	12	Numeric
350	Fair Market Value C	Cg	12	Numeric
355	Method Used C	Ch	20	Alphanumeric
360	Contribution Date D	Dc	6	MMDDYY
370	Date Acquired D	Dd	4	MMYY
380	How Acquired D	De	11	Alphanumeric
390	Cost or Basis D	Df	12	Numeric
400	Fair Market Value D	Dg	12	Numeric
405	Method Used D	Dh	20	Alphanumeric
410	Contribution Date E	Ec	6	MMDDYY
420	Date Acquired E	Ed	4	MMYY
430	How Acquired E	Ee	11	Alphanumeric
440	Cost or Basis E	Ef	12	Numeric
450	Fair Market Value E	Eg	12	Numeric
455	Method Used E	Eh	20	Alphanumeric
*457	Property ID Letter	2a	6	Alphanumeric ("abbbbb" or "STMbnn")
+460	Amount This Year	2b	12	Numeric
+470	Amount Prior Year	2b	12	Numeric
+480	Name Donee	2c	25	Alphanumeric
+490	Number & Street	2c	25	Alphanumeric
+*500	City, State, Zip	2c	25	Alphanumeric or "STMbnn"
+510	Place Kept	2d	25	Alphanumeric
+520	Name of Person	2e	25	Alphanumeric
530	Restriction YES	3a	1	"X" or Blank
540	Restriction NO	3a	1	"X" or Blank
550	Give Rights YES	3b	1	"X" or Blank
560	Give Rights NO	3b	1	"X" or Blank
570	Restriction on Use YES	3c	1	"X" or Blank
580	Restriction on Use NO	3c	1	"X" or Blank

Sec. 28 Form 8283, Page 2

	Byte Count		4	"0448" for fixed; "nnnn" for variable format
590	Record ID		26	Value "FRMb8283bbnn PG02bnnnnnnnnn" (n = P-SSN)
600	Date Received	B1	6	MMDDYY
610	Donee Name	B1	35	Alphanumeric
620	Employer ID	B1	9	Numeric
630	Number & Street	B1	25	Alphanumeric
640	City, State, Zip	B1	25	Alphanumeric
641	Property Type—Art $20,000 or More	B2	1	NO ENTRY
642	Property Type—Real Estate	B2	1	"X" or Blank
643	Property Type—Gem/Jewelry	B2	1	"X" or Blank
644	Property Type—Stamps	B2	1	"X" or Blank
645	Property Type—Art Less Than $20,000	B2	1	"X" or Blank
646	Property Type—Coins	B2	1	"X" or Blank
647	Property Type—Books	B2	1	"X" or Blank
648	Property Type—Other	B2	1	"X" or Blank
*650	Descrip of Prop (1)	B3a	25	Alphanumeric or "STMbnn"
+660	Date Acquired (1)	B3b	4	MMYY
+670	How Acquired (1)	B3c	11	Alphanumeric
+680	Cost or Basis (1)	B3d	12	Numeric
+690	Fair Market Value (1)	B3e	12	Numeric
700	Descrip of Prop (2)	B3a	25	Alphanumeric

Field No.	Identification	Form Ref.	Length	Field Description
710	Date Acquired (2)	B3b	4	MMYY
720	How Acquired (2)	B3c	11	Alphanumeric
730	Cost or Basis (2)	B3d	12	Numeric
740	Fair Market Value (2)	B3e	12	Numeric
750	Descrip of Prop (3)	B3a	25	Alphanumeric
760	Date Acquired (3)	B3b	4	MMYY
770	How Acquired (3)	B3c	11	Alphanumeric
780	Cost or Basis (3)	B3d	12	Numeric
790	Fair Market Value (3)	B3e	12	Numeric
800	Descrip of Prop (4)	B3a	25	Alphanumeric
810	Date Acquired (4)	B3b	4	MMYY
820	How Acquired (4)	B3c	11	Alphanumeric
830	Cost or Basis (4)	B3d	12	Numeric
840	Fair Market Value (4)	B3e	12	Numeric
850	Condition Summary	B4	50	Alphanumeric
860	Identifying Letters of Items $500 or Less	III	4	Alpha

NOTE: When PG02, Form 8283, is significant, a completed page 2 of the paper Form 8283 must be attached to the Form 8453, Taxpayer Declaration. Enter a "1" in Field 34, Paper Document Indicator 8, of the Summary Record.

Sec. 29 Form 8582

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"0402" for fixed; "nnnn" for variable format
000	Record ID		26	Value "FRMb8582bbnn PG01bnnnnnnnnn" (n = P-SSN)
003	Pre-10/23/86 Rental Real Estate Net Income	1a	12	Numeric
007	Pre-10/23/86 Rental Real Estate Net Loss	1b	12	Numeric
010	Pre-10/23/86 Rental Real Estate Net Income/Loss	1c	12	Numeric
013	Post-10/23/86 Rental Real Estate Net Income	1d	12	Numeric
017	Post-10/23/86 Rental Real Estate Net Loss	1e	12	Numeric
020	Post-10/23/86 Rental Real Estate Net ncome/Loss	1f	12	Numeric
030	Total Rental Real Estate Net Income/Loss	1g	12	Numeric
033	Pre-10/23/86 Other Net Income	2a	12	Numeric
037	Pre-10/23/86 Other Net Loss	2b	12	Numeric
040	Pre-10/23/86 Other Net Income/Loss	2c	12	Numeric
043	Post-10/23/86 Other Net Income	2d	12	Numeric
047	Post-10/23/86 Other Net Loss	2e	12	Numeric
050	Post-10/23/86 Other Net Income/Loss	2f	12	Numeric
060	Total Other Net Income/Loss	2g	12	Numeric
080	Passive Activity Income/Loss	3	12	Numeric
090	Loss from Line 1g or Line 3	4	12	Numeric
095	150,000 or 75,000	5	12	Numeric
105	Modified Adjusted Gross Income	6	12	Numeric
115	Line 5 Minus Line 6	7	12	Numeric
125	Line 7 Times .50 or Maximum	8	12	Numeric
135	Smaller of Line 4 or Line 8	9	12	Numeric
145	Sum of Line 1c and Line 2c	10	12	Numeric
155	Zero or Smaller of Line 1c or Line 8	11	12	Numeric
165	Line 10 Minus Line 11	12	12	Numeric
175	Line 3 Minus Line 9	13	12	Numeric
185	Smaller of Line 12 or Line 13	14	12	Numeric
195	Line 14 Times .65	15	12	Numeric
205	Line 9 Amount	16	12	Numeric
215	Line 15 Plus Line 16	17	12	Numeric
225	Total Income on Lines 1a, 1d, 2a and 2d	18	12	Numeric
235	Line 17 Plus Line 18	19	12	Numeric

Sec. 30 Form 8598, Page 1

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"0134" for fixed; "nnnn" for variable format
000	Record ID		26	Value "FRMb8598bbnn PG01bnnnnnnnnn" (n = P-SSN)
010	Sum of 1987 Average Balances	1	12	Numeric
013	Qualified Educational & Medical Expense Literal		3	"QEM" or blank
017	Qualified Educational & Medical Expense Amount		12	Numeric
020	Cost of Home Plus Improvements	2	12	Numeric
030	Pre-August 17 Amount	3	12	Numeric
040	Larger of Line 2 or 3	4	12	Numeric
050	Total Mortgage Interest Paid in 1987	5	12	Numeric
060	Line 1 Divided by Line 4	6	5	Numeric
070	Line 5 Times Line 6	7	12	Numeric
080	Line 5 Minus Line 7	8	12	Numeric

Sec. 31 Form 8598, Page 2

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"0585" for fixed; "nnnn" for variable format
100	Record ID		26	Value "FRMb8598bbnn PG02bnnnnnnnnn" (n = P-SSN)
110	Date of Original Debt	1A	4	Value "MMYY"
120	Average Balance of Original Debt	2A	12	Numeric
130	Part I, Line 4 Amount	3A	12	Numeric
140	Medical/ Educational Expenses, Col A	4aA	12	Numeric
150	Line 4b, Col A	4bA	12	"00000000000"
160	Line 4a, Col A, Amount	4cA	12	Numeric
170	Sum of Lines 3 and 4c, Col A	5A	12	Numeric
180	Smaller of Line 5, Col A or Fair Market Value	6A	12	Numeric
190	Line 7, Col A	7A	12	"00000000000"
200	Line 8, Col A	8A	12	"00000000000"
210	Sum of Lines 7 and 8, Col A	9A	12	"00000000000"
220	Line 6 Minus Line 9, Col A	10A	12	Numeric
230	Total Interest Paid on Debt in 1987, Col A	11A	12	Numeric
240	Line 10 Divided by Line 2, Col A	12A	5	Numeric
250	Line 11 Times Line 12 Col A	13A	12	Numeric
260	Line 11 Minus Line 13 Col A	14A	12	Numeric
270	Date of Second Debt	1B	4	Value "MMYY"
280	Average Balance of Second Debt	2B	12	Numeric
290	Part I, Line 4 Amount	3B	12	Numeric
300	Medical/ Educational Expenses, Col B	4aB	12	Numeric
310	Col A, Line 4a Amount	4bB	12	Numeric
320	Total Lines 4a and 4b, Col B	4cB	12	Numeric
330	Sum of Lines 3 and 4c, Col B	5B	12	Numeric
340	Smaller of Line 5, Col B or Fair Market Value	6B	12	Numeric
350	Col A, Line 9 Amount	7B	12	"00000000000"
360	Smaller of Line 2, Col A or Line 10, Col A	8B	12	Numeric
370	Sum of Lines 7 and 8, Col B	9B	12	Numeric
380	Line 6 Minus Line 9, Col B	10B	12	Numeric
390	Total Interest Paid on Second Debt in 1987	11B	12	Numeric
400	Line 10 Divided by Line 2, Col B	12B	5	Numeric
410	Line 11 Times Line 12 Col B	13B	12	Numeric
420	Line 11 Minus Line 13 Col B	14B	12	Numeric
430	Date of Third Debt	1C	4	Value "MMYY"
440	Average Balance of Third Debt	2C	12	Numeric
450	Part I, Line 4 Amount	3C	12	Numeric

Field No.	Identification	Form Ref.	Length	Field Description
460	Medical/ Educational Expenses, Col C	4aC	12	Numeric
470	Col B, Line 4 Amount	4bC	12	Numeric
480	Sum of Lines 4a and 4b Col C	4cC	12	Numeric
490	Sum of Lines 3 and 4c, Col C	5C	12	Numeric
500	Smaller of Line 5, Col C or Fair Market Value	6C	12	Numeric
510	Col B, Line 9 Amount	7C	12	Numeric
520	Smaller of Col B, Line 2 or Col B, Line 10	8C	12	Numeric
530	Sum of Lines 7 and 8, Col C	9C	12	Numeric
540	Line 6 Minus Line 9, Col C	10C	12	Numeric
550	Total Interest Paid on Third Debt in 1987	11C	12	Numeric
560	Line 10 Divided by Line 2, Col C	12C	5	Numeric
570	Line 11 Times Line 12 Col C	13C	12	Numeric
580	Line 11 Minus Line 13 Col C	14C	12	Numeric
590	Total of Line 13, Col A, B and C Amounts	15	12	Numeric
600	Total of Line 14, Col A, B and C Amounts	16	12	Numeric

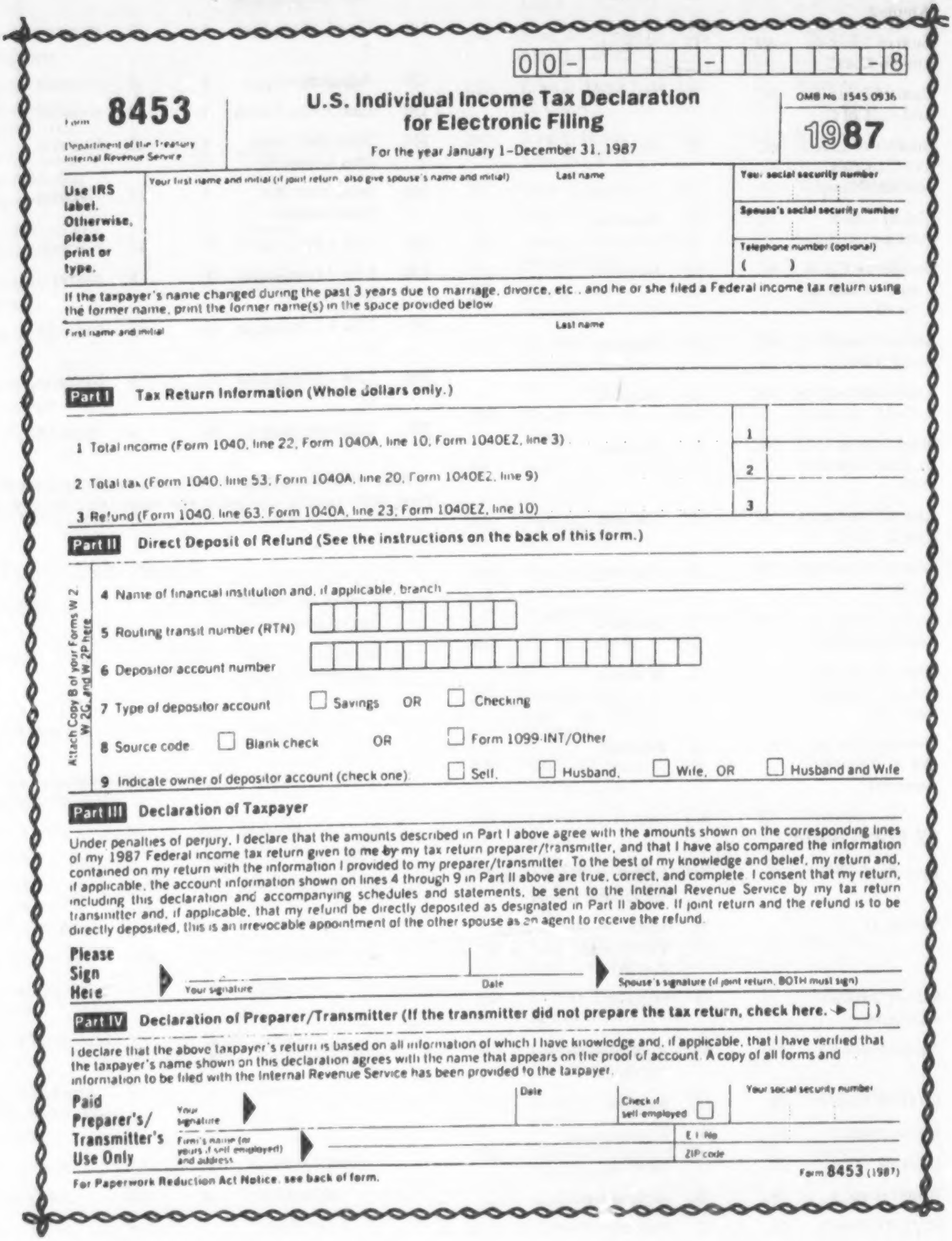
Sec. 32 Form 8606

Field No.	Identification	Form Ref.	Length	Field Description
	Byte Count		4	"0393" for fixed; "nnnn" for variable format
000	Record ID		26	Value "FRMb8606bbnn PG01bnnnnnnnnn" (n = P-SSN)
010	SSN of Taxpayer with IRAs		9	Numeric
*020	Trustee Name 1	1a	60	Alphanumeric or "STMbnn"
+030	12/31/87 Value 1	1a	12	Numeric
040	Trustee Name 2	1b	60	Alphanumeric
050	12/31/87 Value 2	1b	12	Numeric
060	Trustee Name 3	1c	60	Alphanumeric
070	12/31/87 Value 3	1c	12	Numeric
080	Total Value of IRAs	2	12	Numeric
090	Nondeductible 1987 Contributions	3	12	Numeric
100	Nondeductible 1988 Contributions	4	12	Numeric
110	Line 3 Minus Line 4	5	12	Numeric
120	Adjustments	6	12	Numeric
130	Line 5 Plus Line 6	7	12	Numeric
140	Total 1987 Value Plus Rollovers	8	12	Numeric
150	Total 1987 IRA Distributions	9	12	Numeric
160	Line 8 Plus Line 9	10	12	Numeric
170	Line 7 Divided by Line 10	11	5	Numeric
180	Line 9 Times Line 11	12	12	Numeric
190	Line 7 Minus Line 12	13	12	Numeric
200	Signature Present	14	1	Value "Y" = Yes; "N" = No

NOTE: When Form 8606 record is transmitted, a copy of the paper Form 8606 must be attached to the Form 8453, Taxpayer Declaration.

Attachment I

Form 8453, U.S. Individual Income Tax Declaration for Electronic Filing



0 0 - ☐☐☐☐ - ☐☐☐☐☐☐ - 8

Form **8453**

Department of the Treasury
Internal Revenue Service

U.S. Individual Income Tax Declaration for Electronic Filing

For the year January 1–December 31, 1987

OMB No. 1545-0936

1987

Use IRS label. Otherwise, please print or type.

Your first name and initial (if joint return, also give spouse's name and initial) | Last name

Your social security number

Spouse's social security number

Telephone number (optional) (   )

If the taxpayer's name changed during the past 3 years due to marriage, divorce, etc., and he or she filed a Federal income tax return using the former name, print the former name(s) in the space provided below

First name and initial | Last name

Part I **Tax Return Information (Whole dollars only.)**

1 Total income (Form 1040, line 22, Form 1040A, line 10, Form 1040EZ, line 3)	1	
2 Total tax (Form 1040, line 53, Form 1040A, line 20, Form 1040EZ, line 9)	2	
3 Refund (Form 1040, line 63, Form 1040A, line 23, Form 1040EZ, line 10)	3	

Part II **Direct Deposit of Refund (See the instructions on the back of this form.)**

Attach Copy B of your Forms W-2, W-2G, and W-2P here

4 Name of financial institution and, if applicable, branch

5 Routing transit number (RTN) ☐☐☐☐☐☐☐☐☐

6 Depositor account number ☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐

7 Type of depositor account ☐ Savings OR ☐ Checking

8 Source code ☐ Blank check OR ☐ Form 1099-INT/Other

9 Indicate owner of depositor account (check one): ☐ Self, ☐ Husband, ☐ Wife, OR ☐ Husband and Wife

Part III **Declaration of Taxpayer**

Under penalties of perjury, I declare that the amounts described in Part I above agree with the amounts shown on the corresponding lines of my 1987 Federal income tax return given to me ~~by~~ my tax return preparer/transmitter, and that I have also compared the information contained on my return with the information I provided to my preparer/transmitter. To the best of my knowledge and belief, my return and, if applicable, the account information shown on lines 4 through 9 in Part II above are true, correct, and complete. I consent that my return, including this declaration and accompanying schedules and statements, be sent to the Internal Revenue Service by my tax return transmitter and, if applicable, that my refund be directly deposited as designated in Part II above. If joint return and the refund is to be directly deposited, this is an irrevocable appointment of the other spouse as an agent to receive the refund.

Please Sign Here ▶ Your signature | Date ▶ Spouse's signature (if joint return, BOTH must sign)

Part IV **Declaration of Preparer/Transmitter (If the transmitter did not prepare the tax return, check here. ▶ ☐)**

I declare that the above taxpayer's return is based on all information of which I have knowledge and, if applicable, that I have verified that the taxpayer's name shown on this declaration agrees with the name that appears on the proof of account. A copy of all forms and information to be filed with the Internal Revenue Service has been provided to the taxpayer.

Paid Preparer's/ Transmitter's Use Only

Your signature ▶ | Date | Check if self-employed ☐ | Your social security number

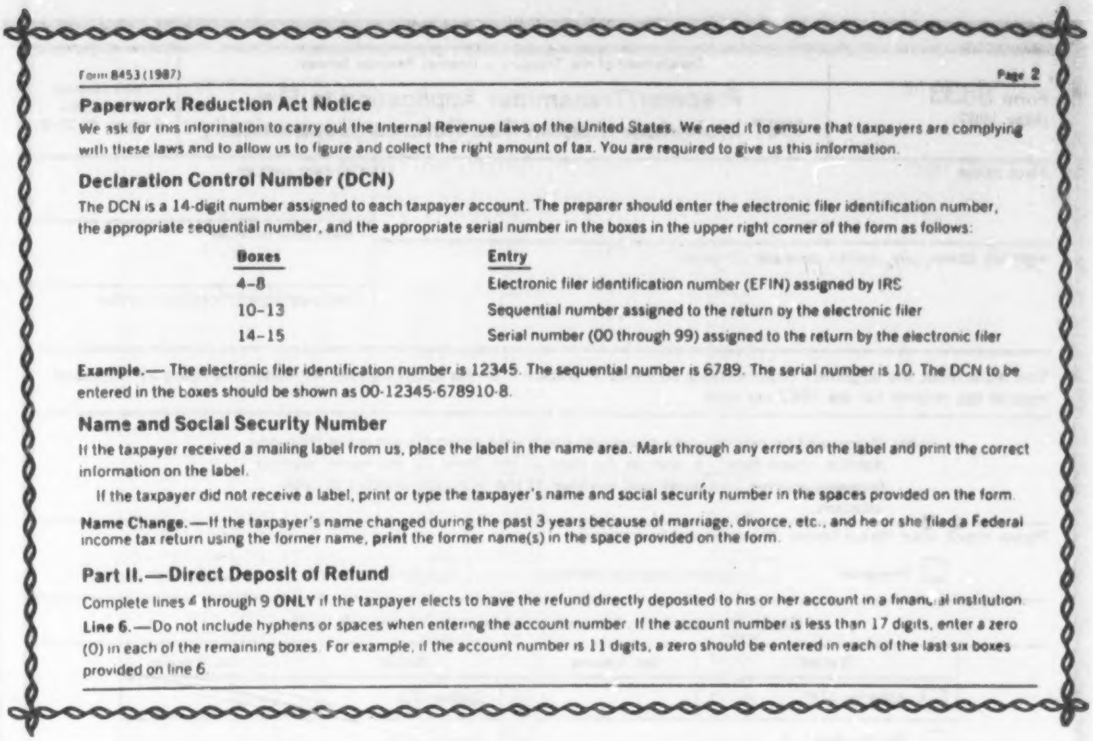
Firm's name (or yours if self-employed) and address ▶ | E.I. No. | ZIP code

For Paperwork Reduction Act Notice, see back of form.

Form **8453** (1987)

Attachment I (Cont)

Form 8453 Instructions



Form 8453 (1987) Page 2

Paperwork Reduction Act Notice

We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Declaration Control Number (DCN)

The DCN is a 14-digit number assigned to each taxpayer account. The preparer should enter the electronic filer identification number, the appropriate sequential number, and the appropriate serial number in the boxes in the upper right corner of the form as follows:

Boxes	Entry
4–8	Electronic filer identification number (EFIN) assigned by IRS
10–13	Sequential number assigned to the return by the electronic filer
14–15	Serial number (00 through 99) assigned to the return by the electronic filer

Example.— The electronic filer identification number is 12345. The sequential number is 6789. The serial number is 10. The DCN to be entered in the boxes should be shown as 00-12345-678910-8.

Name and Social Security Number

If the taxpayer received a mailing label from us, place the label in the name area. Mark through any errors on the label and print the correct information on the label.

If the taxpayer did not receive a label, print or type the taxpayer's name and social security number in the spaces provided on the form.

Name Change.—If the taxpayer's name changed during the past 3 years because of marriage, divorce, etc., and he or she filed a Federal income tax return using the former name, print the former name(s) in the space provided on the form.

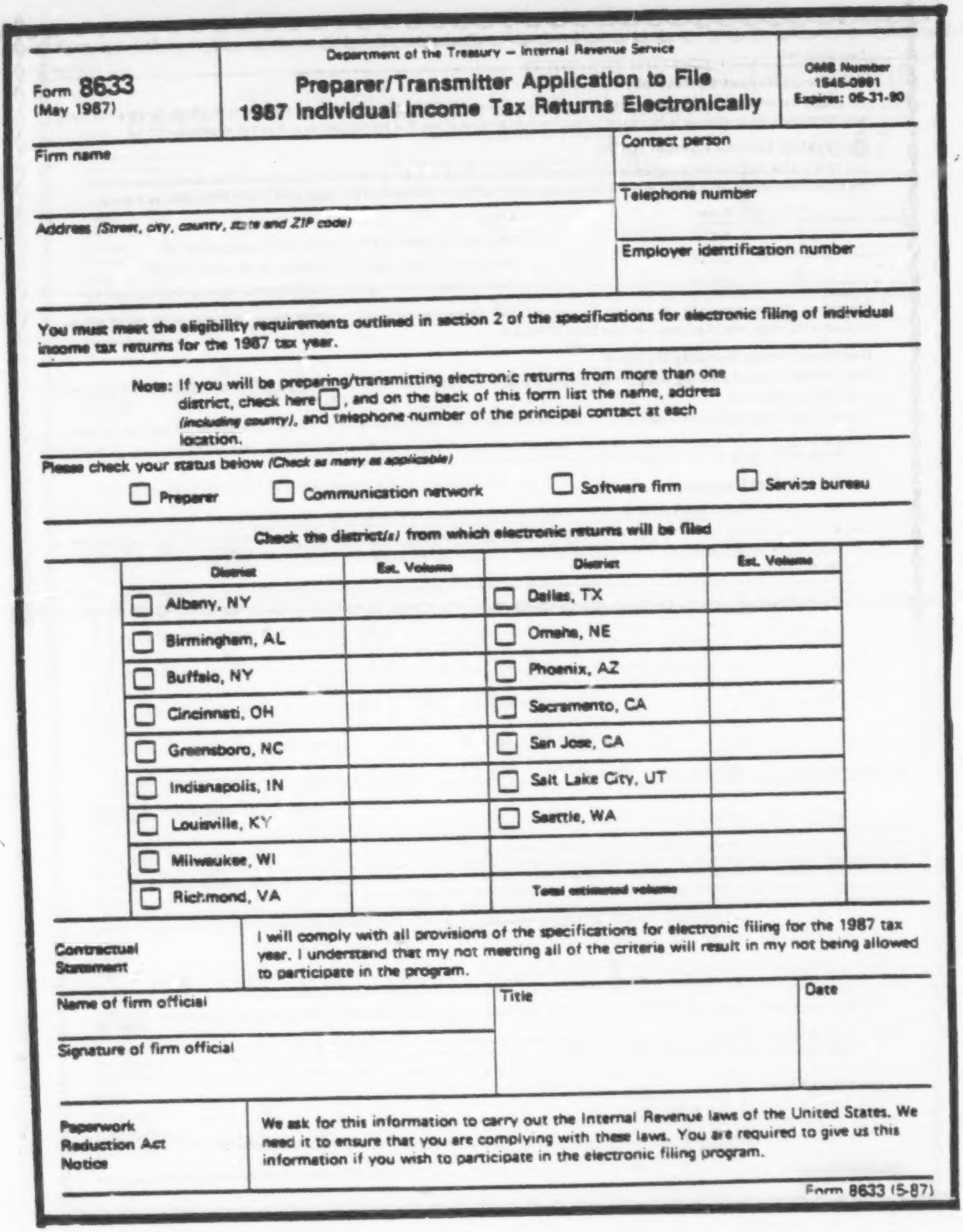
Part II.—Direct Deposit of Refund

Complete lines 4 through 9 **ONLY** if the taxpayer elects to have the refund directly deposited to his or her account in a financial institution.

Line 6.—Do not include hyphens or spaces when entering the account number. If the account number is less than 17 digits, enter a zero (0) in each of the remaining boxes. For example, if the account number is 11 digits, a zero should be entered in each of the last six boxes provided on line 6.

Attachment II

Form 8633, Preparer/Transmitter Application To File 1987 Individual Income Tax Returns Electronically



Form **8633**
(May 1987)

Department of the Treasury – Internal Revenue Service

Preparer/Transmitter Application to File 1987 Individual Income Tax Returns Electronically

OMB Number 1545-0981
Expires: 05-31-90

Firm name

Contact person

Telephone number

Address *(Street, city, country, state and ZIP code)*

Employer identification number

You must meet the eligibility requirements outlined in section 2 of the specifications for electronic filing of individual income tax returns for the 1987 tax year.

Note: If you will be preparing/transmitting electronic returns from more than one district, check here ☐, and on the back of this form list the name, address *(including county)*, and telephone number of the principal contact at each location.

Please check your status below *(Check as many as applicable)*

☐ Preparer ☐ Communication network ☐ Software firm ☐ Service bureau

Check the district(s) from which electronic returns will be filed

District	Est. Volume	District	Est. Volume
☐ Albany, NY		☐ Dallas, TX	
☐ Birmingham, AL		☐ Omaha, NE	
☐ Buffalo, NY		☐ Phoenix, AZ	
☐ Cincinnati, OH		☐ Sacramento, CA	
☐ Greensboro, NC		☐ San Jose, CA	
☐ Indianapolis, IN		☐ Salt Lake City, UT	
☐ Louisville, KY		☐ Seattle, WA	
☐ Milwaukee, WI			
☐ Richmond, VA		Total estimated volume	

Contractual Statement I will comply with all provisions of the specifications for electronic filing for the 1987 tax year. I understand that my not meeting all of the criteria will result in my not being allowed to participate in the program.

Name of firm official

Title

Date

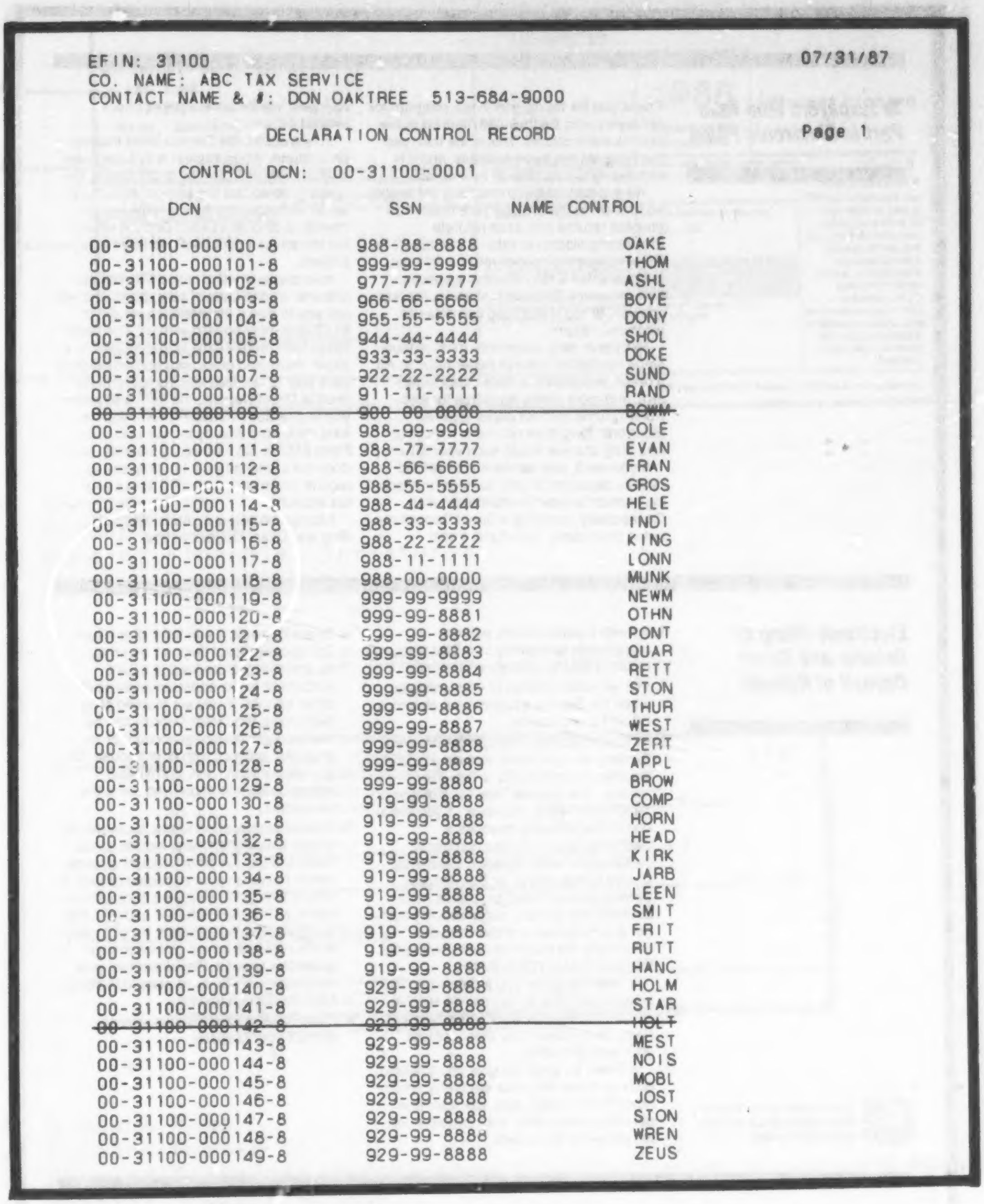
Signature of firm official

Paperwork Reduction Act Notice We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that you are complying with these laws. You are required to give us this information if you wish to participate in the electronic filing program.

Form 8633 (5-87)

Attachment III

Declaration Control Record



EFIN: 31100 07/31/87

CO. NAME: ABC TAX SERVICE

CONTACT NAME & #: DON OAKTREE 513-684-9000

DECLARATION CONTROL RECORD Page 1

CONTROL DCN: 00-31100-0001

DCN	SSN	NAME CONTROL
00-31100-000100-8	988-88-8888	OAKE
00-31100-000101-8	999-99-9999	THOM
00-31100-000102-8	977-77-7777	ASHL
00-31100-000103-8	966-66-6666	BOYE
00-31100-000104-8	955-55-5555	DONY
00-31100-000105-8	944-44-4444	SHOL
00-31100-000106-8	933-33-3333	DOKE
00-31100-000107-8	922-22-2222	SUND
00-31100-000108-8	911-11-1111	RAND
~~00-31100-000109-8~~	~~900-00-0000~~	~~BOWM~~
00-31100-000110-8	988-99-9999	COLE
00-31100-000111-8	988-77-7777	EVAN
00-31100-000112-8	988-66-6666	FRAN
00-31100-000113-8	988-55-5555	GROS
00-31100-000114-8	988-44-4444	HELE
00-31100-000115-8	988-33-3333	INDI
00-31100-000116-8	988-22-2222	KING
00-31100-000117-8	988-11-1111	LONN
00-31100-000118-8	988-00-0000	MUNK
00-31100-000119-8	999-99-9999	NEWM
00-31100-000120-8	999-99-8881	OTHN
00-31100-000121-8	999-99-8882	PONT
00-31100-000122-8	999-99-8883	QUAR
00-31100-000123-8	999-99-8884	RETT
00-31100-000124-8	999-99-8885	STON
00-31100-000125-8	999-99-8886	THUR
00-31100-000126-8	999-99-8887	WEST
00-31100-000127-8	999-99-8888	ZERT
00-31100-000128-8	999-99-8889	APPL
00-31100-000129-8	999-99-8880	BROW
00-31100-000130-8	919-99-8888	COMP
00-31100-000131-8	919-99-8888	HORN
00-31100-000132-8	919-99-8888	HEAD
00-31100-000133-8	919-99-8888	KIRK
00-31100-000134-8	919-99-8888	JARB
00-31100-000135-8	919-99-8888	LEEN
00-31100-000136-8	919-99-8888	SMIT
00-31100-000137-8	919-99-8888	FRIT
00-31100-000138-8	919-99-8888	RUTT
00-31100-000139-8	919-99-8888	HANC
00-31100-000140-8	929-99-8888	HOLM
00-31100-000141-8	929-99-8888	STAR
~~00-31100-000142-8~~	~~929-99-8888~~	~~HOLT~~
00-31100-000143-8	929-99-8888	MEST
00-31100-000144-8	929-99-8888	NOIS
00-31100-000145-8	929-99-8888	MOBL
00-31100-000146-8	929-99-8888	JOST
00-31100-000147-8	929-99-8888	STON
00-31100-000148-8	929-99-8888	WREN
00-31100-000149-8	929-99-8888	ZEUS

Attachment IV

Notice 811, To Taxpayers Who Take Part in Electronic Filing

To Taxpayers Who Take Part in Electronic Filing

Thank you for taking part in our program for taxpayers who file their 1987 individual tax returns electronically. This is the third year the program has been available, and it is expanding to a number of new areas.

We expect that electronic filing will enable us to shorten the average time needed to process returns and issue refunds. Processing electronic returns can take 2 to 3 weeks less than paper returns. We cannot guarantee a refund within a specific time, however. Errors in the return, the transmission, or the processing can delay an electronic return.

Electronic filing automates most manual steps needed to process paper returns. As a result, processing is faster, less expensive, and more nearly error-free for electronic returns than for paper returns. Electronic filing does not make it more or less likely that we would audit your return.

If you want, you can have your refund directly deposited in your savings or checking account at your financial institution. Occasionally, honoring a Direct Deposit request could delay the refund. If that happens, we will issue a paper check instead.

In rare cases, the Service owes interest on a refund. When interest is included with a refund that IRS pays by paper check, the check is noted that the amount includes interest. IRS does not send a notice when interest is paid on a Direct Deposit refund, but the amount deposited would include interest.

Your preparer will give you the required preparer-signed copy of your return and will ask you to sign a declaration form, Form 8453, that must be filed with us. The declaration form replaces the signature part of a paper return and gives your authorization to have your return filed electronically. If you choose Direct Deposit, the form also allows you to give authorization to have your refund deposited directly to your account. Form 8453 is not a power of attorney, so it does not authorize your tax preparer to receive information from IRS about your tax account.

Information below explains electronic filing and Direct Deposit further.

Electronic Filing of Returns and Direct Deposit of Refunds

1. As with a paper return, **you** are responsible for making sure that your return is filed accurately and on time.
2. IRS will acknowledge to your preparer when the Service accepts your electronic return for processing.
3. **Refund inquiries.** You can get answers to many tax questions, including refund inquiries, by calling IRS's Tele-Tax system. The general Tele-Tax number is 1-(800)-554-4477. However, if you live in one of the following counties in California, your Tele-Tax number is 1-(800)-428-4032: Amador, Calaveras, Contra Costa, Marin, or San Joaquin. Before you call Tele-Tax, please have available the primary social security number and filing status shown on your return and the exact amount you expect. DO NOT CALL YOUR BANK.

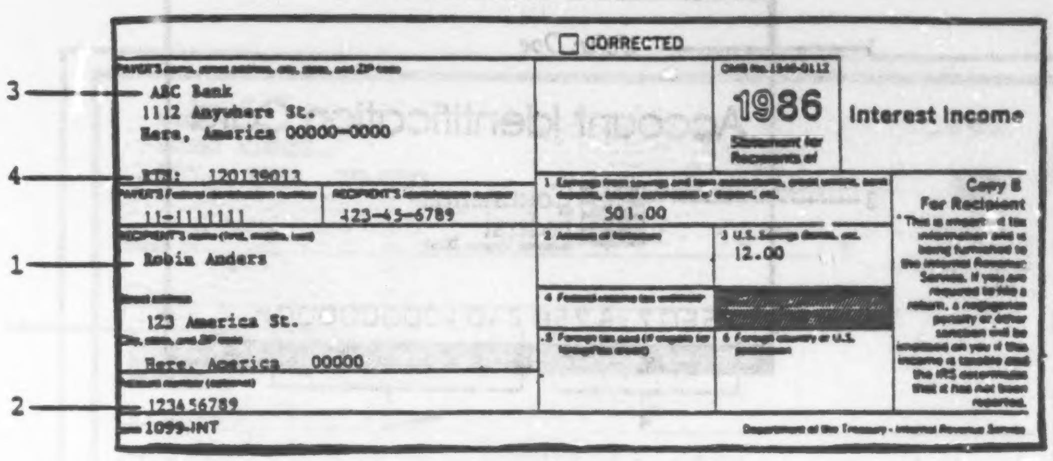
   If Tele-Tax gives you a date when IRS issued your refund, you should receive the refund within a week after that date. If you do not have it by then, contact your local IRS office.

   If Tele-Tax does **not** give you a refund date, and you filed your electronic return more than 4 weeks ago, ask your preparer to contact IRS. Your preparer will tell you what to do next.
4. **Direct Deposit.** If you file a joint return and choose Direct Deposit, you may have the refund credited to a joint account or to the separate account of either spouse. If you are married filing separately, the Direct Deposit can be made only to your own account or to your joint account with your spouse. On your declaration form, Form 8453, please be sure to show who owns the account.
5. **Refund anticipation loans.** Examples of refund anticipation loans include actual loans and certain other account arrangements based on your expected refund. A refund anticipation loan is a contract between a financial institution and you, the taxpayer. The Government is not a party to the contract, so we cannot answer questions about it. Please contact your tax preparer if you have questions about a refund anticipation loan.
6. If you have other questions, please contact your preparer.

Department of the Treasury
Internal Revenue Service
Notice 811 (1-88)

Attachment V

Proof of Account - Form 1099-INT



☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code
ABC Bank
1112 Anywhere St.
Here, America 00000-0000

RTN: 120139013

OMB No. 1545-0112
1986
Statement for Recipients of
Interest Income

PAYER'S Federal identification number: 11-1111111
RECIPIENT'S identification number: 123-45-6789

1 Earnings from savings and loan associations, credit unions, bank deposits, bearer certificates of deposit, etc.: 501.00

RECIPIENT'S name (first, middle, last)
Robin Anders

2

3 U.S. Savings Bonds, etc.: 12.00

Street address
123 America St.

4 Federal income tax withheld

City, state, and ZIP code
Here, America 00000

5 Foreign tax paid (if eligible for foreign tax credit)

6 Foreign country or U.S. possession

Account number (optional)
123456789

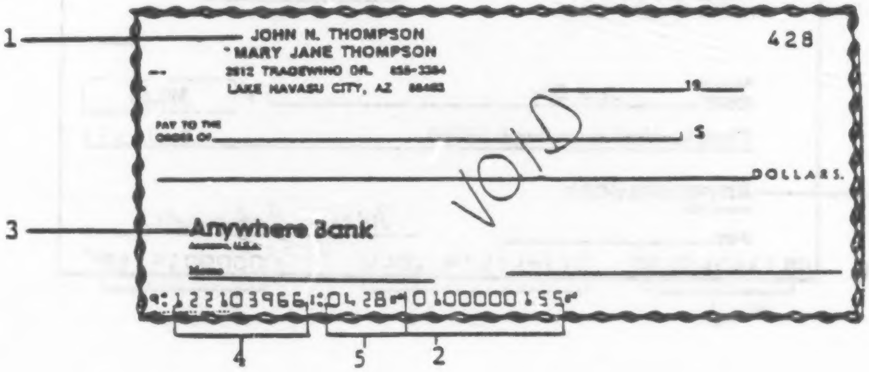
Copy B
For Recipient
This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form 1099-INT

Department of the Treasury - Internal Revenue Service

1 Account Name
2 Account Number
3 Name of Financial Institution
4 Routing Transit Number

Proof of Account - Blank Check



JOHN N. THOMPSON
MARY JANE THOMPSON
2812 TRADEWIND DR. 855-3384
LAKE HAVASU CITY, AZ 86403

428

19

PAY TO THE ORDER OF $

DOLLARS

VOID

Anywhere Bank
Anywhere, U.S.A.

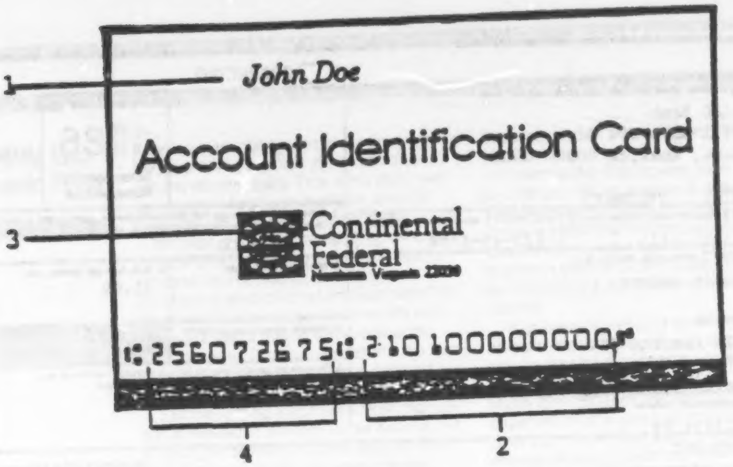
Memo

⑆122103966⑆0428⑈0100000155⑈

1 Account Name
2 Account Number
3 Name of Financial Institution
4 Routing Transit Number
5 Check Serial Number

Attachment V (Cont)

Proof of Account - Other



John Doe

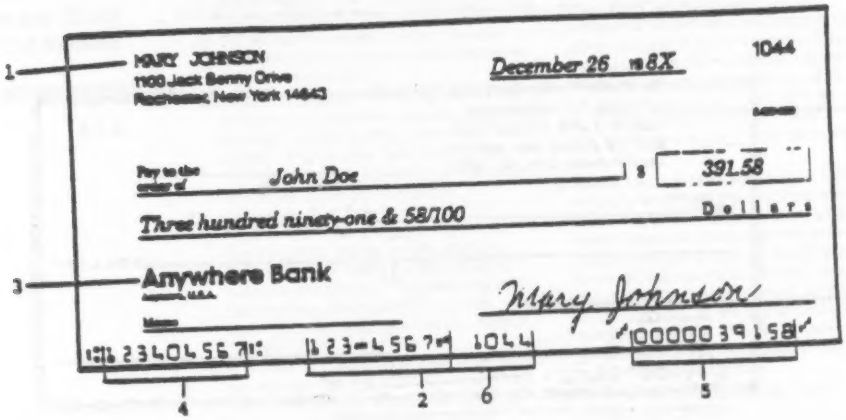
Account Identification Card

Continental Federal

256072675 210 100000000

1 Account Name
2 Account Number
3 Name of Financial Institution
4 Routing Transit Number

Proof of Account - Cancelled Check



MARY JOHNSON
1100 Jack Benny Drive
Rochester, New York 14643

December 26 19*8X*

1044

Pay to the order of *John Doe* $ *391.58*

Three hundred ninety-one & 58/100 Dollars

Anywhere Bank
Anywhere, U.S.A.

Memo

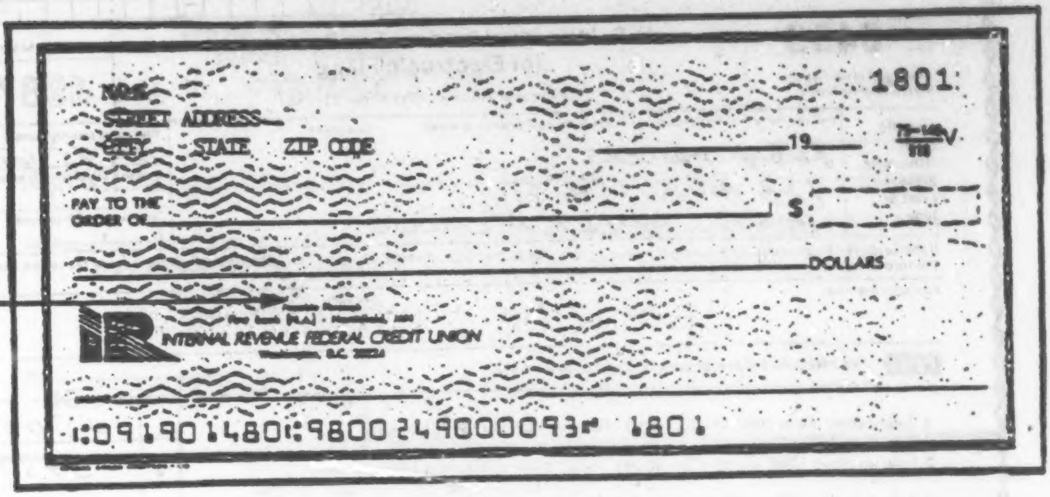
Mary Johnson

123404567 123-4567 1044 0000039158

1 Account Name
2 Account Number
3 Name of Financial Institution
4 Routing Transit Number
5 Money Amount
6 Check Serial Number

Attachment VI

Unacceptable Proof of Account
Check Payable through Another Financial Institution



NAME

STREET ADDRESS

CITY STATE ZIP CODE

1801

19

PAY TO THE ORDER OF

$

DOLLARS

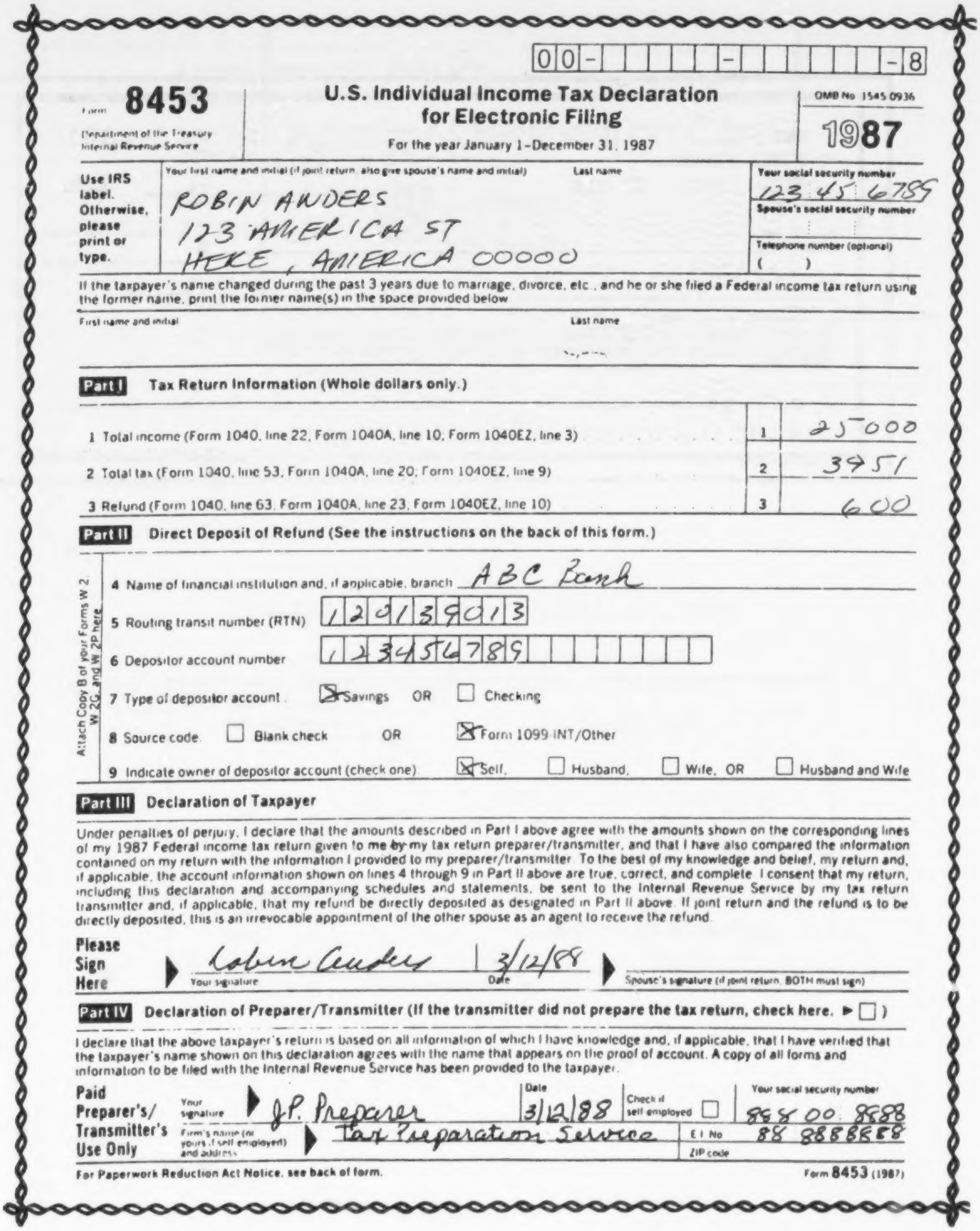
INTERNAL REVENUE FEDERAL CREDIT UNION

⑆091901480⑆9800249000093⑈ 1801

Acceptable Proof of Account
for Check Payable through Another Financial Institution

Attachment VII

Direct Deposit Data on Form 8453



0 0 - ☐☐☐☐☐ - ☐☐☐☐☐☐ - 8

Form **8453**
Department of the Treasury
Internal Revenue Service

U.S. Individual Income Tax Declaration for Electronic Filing

For the year January 1–December 31, 1987

OMB No 1545 0936

1987

Use IRS label. Otherwise, please print or type.

Your first name and initial (if joint return, also give spouse's name and initial) Last name
ROBIN ANDERS
123 AMERICA ST
HERE, AMERICA 00000

Your social security number: 123 45 6785
Spouse's social security number:
Telephone number (optional): (   )

If the taxpayer's name changed during the past 3 years due to marriage, divorce, etc., and he or she filed a Federal income tax return using the former name, print the former name(s) in the space provided below

First name and initial Last name

Part I **Tax Return Information (Whole dollars only.)**

1 Total income (Form 1040, line 22, Form 1040A, line 10, Form 1040EZ, line 3)	1	25000
2 Total tax (Form 1040, line 53, Form 1040A, line 20, Form 1040EZ, line 9)	2	3951
3 Refund (Form 1040, line 63, Form 1040A, line 23, Form 1040EZ, line 10)	3	600

Part II **Direct Deposit of Refund (See the instructions on the back of this form.)**

Attach Copy B of your Forms W 2, W 2G, and W 2P here

4 Name of financial institution and, if applicable, branch ABC Bank
5 Routing transit number (RTN) 120139013
6 Depositor account number 123456789
7 Type of depositor account ☒ Savings OR ☐ Checking
8 Source code ☐ Blank check OR ☒ Form 1099-INT/Other
9 Indicate owner of depositor account (check one) ☒ Self, ☐ Husband, ☐ Wife, OR ☐ Husband and Wife

Part III **Declaration of Taxpayer**

Under penalties of perjury, I declare that the amounts described in Part I above agree with the amounts shown on the corresponding lines of my 1987 Federal income tax return given to me ~~by~~ my tax return preparer/transmitter, and that I have also compared the information contained on my return with the information I provided to my preparer/transmitter. To the best of my knowledge and belief, my return and, if applicable, the account information shown on lines 4 through 9 in Part II above are true, correct, and complete. I consent that my return, including this declaration and accompanying schedules and statements, be sent to the Internal Revenue Service by my tax return transmitter and, if applicable, that my refund be directly deposited as designated in Part II above. If joint return and the refund is to be directly deposited, this is an irrevocable appointment of the other spouse as an agent to receive the refund.

Please Sign Here ▶ Robin Anders 3/12/88 ▶
Your signature Date Spouse's signature (if joint return, BOTH must sign)

Part IV **Declaration of Preparer/Transmitter (If the transmitter did not prepare the tax return, check here. ▶ ☐)**

I declare that the above taxpayer's return is based on all information of which I have knowledge and, if applicable, that I have verified that the taxpayer's name shown on this declaration agrees with the name that appears on the proof of account. A copy of all forms and information to be filed with the Internal Revenue Service has been provided to the taxpayer.

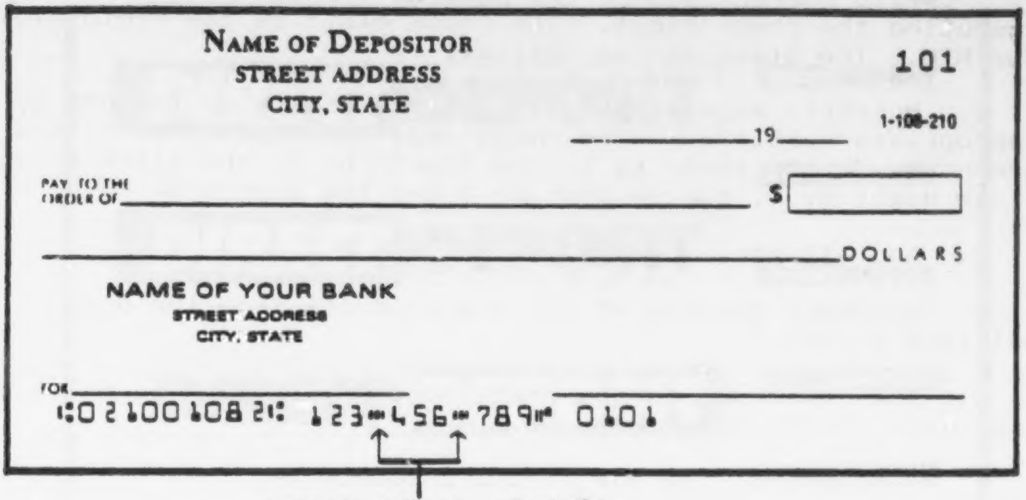
Paid Preparer's/ Transmitter's Use Only
Your signature ▶ J.P. Preparer
Date 3/12/88
Check if self employed ☐
Your social security number 888 00 8888
Firm's name (or yours, if self employed) and address ▶ Tax Preparation Service
E I No 88 8888888
ZIP code

For Paperwork Reduction Act Notice, see back of form. Form **8453** (1987)

best copy available

Attachment VIII

MICR Dash/Hyphen Symbols



NAME OF DEPOSITOR
STREET ADDRESS
CITY, STATE

101

1-108-210

____________19____

PAY TO THE ORDER OF____________________ $☐

____________________DOLLARS

NAME OF YOUR BANK
STREET ADDRESS
CITY, STATE

FOR________________

⑆021001082⑆ 123⑉456⑉789⑈ 0101

MICR Dash/Hyphen Symbols

Attachment IX

Validation of Routing Transit Number

Verify correctness of the Routing Transit Number by computing the check digit. The check digit is the ninth digit of the RTN. The steps are as follows:

1. Multiply each of the first eight digits of the RTN by the appropriate multiplier (the first digit multiplied by 3, the second by 7, the third by 1, the fourth by 3, the fifth by 7, the sixth digit by 1, the seventh by 3 and the eighth by 7).

2. Add all the products.

3. Subtract the sum of all the products from the next multiple of ten.

4. The remainder is the check digit which must be equal to the ninth digit of the RTN.

Note: If the sum of the products is evenly divisible by 10, the check digit is zero (0).

For example, if 120139013 were the RTN, verify the check digit as follows:

1. Multiply each of the first eight digits, 12013901, by 37137137 respectively:

Routing Transit Number	1	2	0	1	3	9	0	1
Constant Multiplier	X3	X7	X1	X3	X7	X1	X3	X7
	3	14	0	3	21	9	0	7

2. Add the products: 3 + 14 + 0 + 3 + 21 + 9 + 0 + 7 = 57

3. Subtract the sum of all the products from the next multiple of ten: 60 - 57 = 3

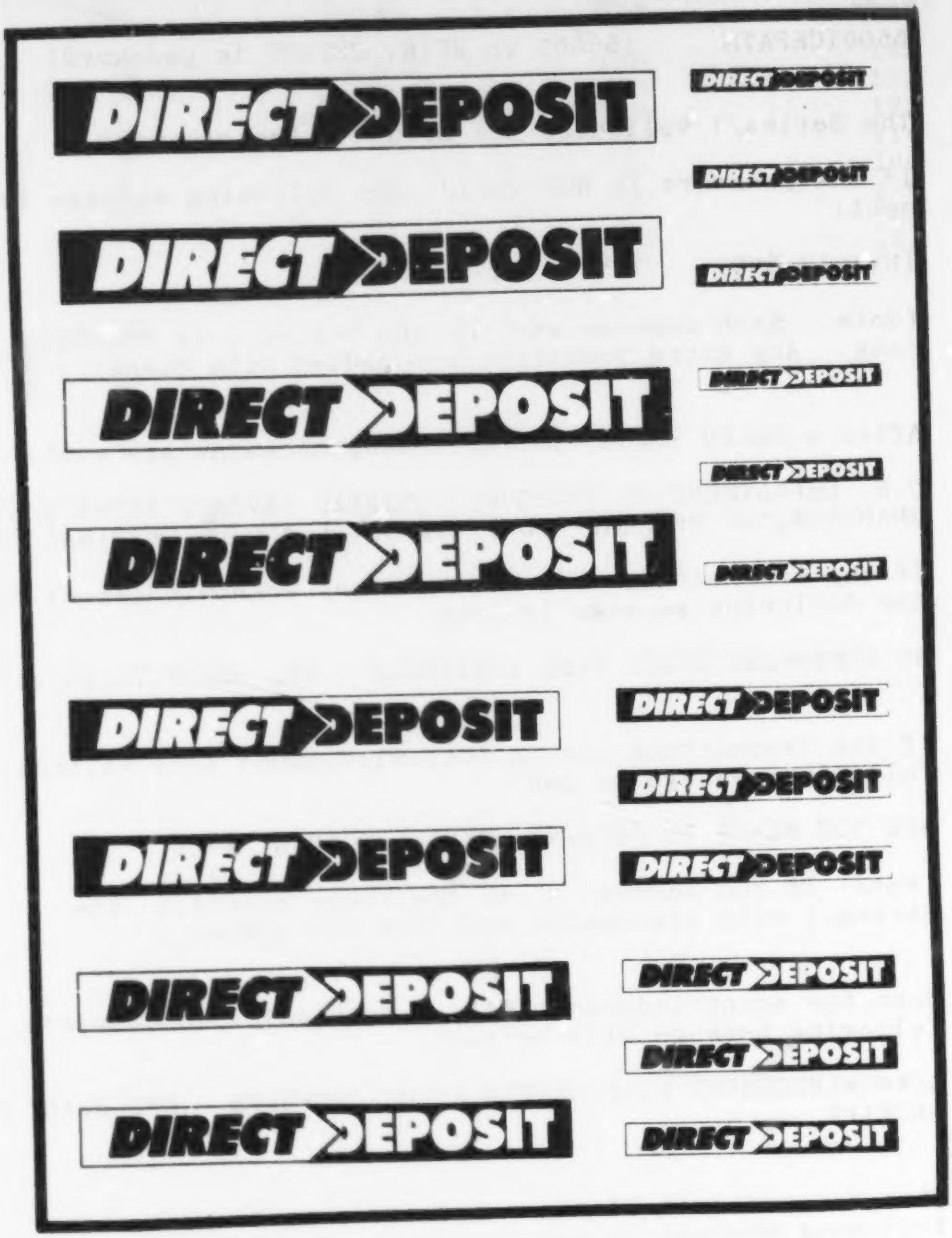
4. The remainder is the check digit: 3

5. If the check digit does not equal the ninth digit of the RTN, verify that the first eight digits of the RTN were correctly entered from the source document and recompute if appropriate.

Note: If the check digit does not match, the refund cannot be directly deposited.

Attachment X

Direct Deposit Logo/Graphic


DIRECT DEPOSIT

Attachment XI

Series/1 To Transmitter Communications Dialogue

1. Transmitter logs on:

   55001CSPATS (55001 is EFIN, CSPATS is password)

2. The Series/1 validates the EFIN and the password.

   If the password is NOT valid, the following message is sent:

   ```
   INVALID ENTRY - TRY AGAIN.
   ```

   (Note: Each message sent by the Series 1 is 80 characters long. Any extra positions are padded with blanks.)

3. After a VALID logon, the following messages are sent:

   ```
   U.S. DEPARTMENT OF TREASURY INTERNAL REVENUE SERVICE SYSTEMS
   UNAUTHORIZED USE MAY RESULT IN CIVIL AND/OR CRIMINAL PENALTIES
   ```

4. If the transmitter does not have any acknowledgement files, the following message is sent:

   ```
   NO ACKNOWLEDGEMENT FILE AVAILABLE - EFS READY TO RECEIVE.
   ```

5. If the transmitter has an acknowledgement file waiting, the following message is sent:

   ```
   ARE YOU READY TO RECEIVE ACKNOWLEDGEMENT FILE ?
   ```

   (Note: If you answer "N" to the above question, the Series/1 will disconnect you from the system.)

6. When the acknowledgement file transmission is complete, the following message will be sent:

   ```
   ACKNOWLEDGEMENT FILE TRANSMISSION COMPLETE - EFS READY TO
   RECEIVE.
   ```

7. When transmission of the return file is complete, the following message is sent and the transmitter is disconnected:

   ```
   TRANSMISSION SUCCESSFUL - DISCONNECT FROM EFS.
   ```

Attachment XII

Special Characters

Symbol	ASCII		EBCDIC	
	Hex	Octal	Hex	Octal
[	5B	133	4A	112
]	5D	135	5A	132
#	23	043	7B	173
<	3C	74	4C	114
-	2D	55	60	140
&	26	46	50	120
/	2F	57	61	141
%	25	45	6C	154

Attachment XIII

Example of Statement Record Schedule B

The following represents a continuation statement for Schedule B interest payors and amounts.

1 The Interest Payor 1 field (SEQ_030) of Schedule B will contain "STMb01".

2 The Statement record (b = blank, 9's = SSN)

```
STMb01bPG01bLN01b999999999_______(30 blanks)_______
SCHEDULEbBbINTEREST___________(31 blanks)_______
STMb01bPG01bLN02b999999999__(15 blanks)__________
PAYOR___(20 blanks)_____AMOUNT____(34 blanks)___
STMb01bPG01bLN03b99999999920161240__(72 blanks)__
STMb01bPG01bLN04b999999999FIRSTbNATIONALbBANKb
00000005000___________(49 blanks)________________
```

Example of Statement Record Schedule D

The following represents a continuation statement for Schedule D Long Term Capital Gains and Losses

1 The Long F1099-B Desc 1 Seq 880 will contain "STM02".

2 The Statement Records (b = blank, 9's = SSN)

```
0110STM02bPG01bLN01b999999999
bbbbbbbbbbbbbbbSCHEDULEbDbLONGbTERMbCAPITALbGAINSbANDbLOSSESbbbbbbbbbbbbbbbbb

0110STM02bPG01bLN02b999999999
DESCRIPTIONbbbbAQUIRDbbSOLDbbbbbPRICEbbbbbbbbCOSTbbbbbbbbLOSSbbbbbbbGAINbbbbb

0110STM02bPG01bLN03b999999999
0115160623063012431256126812bbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbbb

0110STM02bPG01bLN04b999999999
100bCOMPANYbAbb12038405038700000002300b000000001000b00000000000b000000001300bbb

0110STM02bPG01bLN05b999999999
200bCOMPANYbBbb01038405038700000001000b000000002300b00000001300b000000000000bbb

0110STM02bPG01bLN06b999999999
300bCOMPANYbCbb12038405038700000002300b000000001000b00000000000b000000001300bbb

0110STM02bPG01bLN07b999999999
400bCOMPANYbDbb01038405038700000001000b000000002300b00000001300b000000000000bbb

0110STM02bPG01bLN08b999999999
500bCOMPANYbAbb12038405038700000002300b000000001000b00000000000b000000001300bbb

0110STM02bPG01bLN09b999999999
600bCOMPANYbEbb11308405038700000001000b000000002300b00000001300b000000000000bbb

0110STM02bPG01bLN10b999999999
700bCOMPANYbFbb12138405038700000002300b000000001000b00000000000b000000001300bbb

0110STM02bPG01bLN11b999999999
800bCOMPANYbGbb01238405038700000001000b000000002300b00000001300b000000000000bbb

0110STM02bPG01bLN12b999999999
900bCOMPANYbCbb10038405038700000002300b000000001000b00000000000b000000001300bbb

0110STM02bPG01bLN13b999999999
100bCOMPANYbDbb11038405038700000001000b000000002300b00000001300b000000000000bbb

0110STM02bPG01bLN14b999999999
110bCOMPANYbAbb05038405038700000002300b000000001000b00000000000b000000001300bbb

0110STM02bPG01bLN15b999999999
120bCOMPANYbBbb07038405038700000001000b000000002300b00000001300b000000000000bbb
```

Attachment XIV

Reject Codes and Explanations

001	Invalid Record ID encountered or Primary SSN not consistent on all schedules, forms, or statements.
002	Key data field is not in the prescribed form as follows: Money amount fields must be numeric, zero-filled and justified to the right. Other numeric fields must not contain any non-numeric fields, are zero-filled, and justified to the right.
003	Tax Period field of Tax Return Record is invalid.
004	SSN (SEQ_010) of Form 1040 Record is not numeric, or SSN is less than 001010000, or SSN is all nines, or (SSN is equal to or greater than 627000000, and SSN is equal to or less than 699999999), or (SSN is equal to or greater than 729000000, and SSN is equal to or less than 899999999).
005	Statement Count is greater than 20.
006	Name Control (SEQ_050) of Form 1040 record is not present, or is in invalid format.
007	Street Address (SEQ_080) of Form 1040 record is not present, or is in invalid format.
008	Filing Status (SEQ_130) of Form 1040 record is not present.
009	Exempt Self (SEQ_160) of Form 1040 is not present.
010	Pages found out of sequence.
011	Total Exemptions (SEQ_360) of Form 1040 record is not significant.
012	Overpayment field of Form 1040 record is not greater than zero.
013	All alpha characters are not in upper case, or Alphanumeric fields are not in proper left-justified format.

Reject Codes and Explanations

014 One of the following fields is significant.
Form 1040: Primary Date of Death, Secondary Date of Death, Other Gain, Farm Income Form 8615 Tax Indicator, Form 4970 Indicator, Form 4972 Indicator, Additional Taxes, Foreign Tax Credit, Form 3800 Credit Indicator, Form 3468 Credit Indicator, Form 5884 Credit Indicator, Form 6478 Credit Indicator Form 6765 Credit Indicator, Form 8586 Credit Indicator, General Business Credit, Total Nonpersonal Credit, Recapture Investment Credit, Railroad Retirement Indicator, Social Security on Tips, Tax on IRA, Form 4868 Amount, Credit for Special Fuels Tax, Form 4469 Indicator, Form 4469 Amount, Regulated Investment Co Credit, Overpaid Windfall Indicator, Overpaid Windfall Amount, Amount Owed, Form 2210 Indicator, Estimated Tax Penalty, Remittance Amount or Refund Indicator; or
Schedule A - Casualty
Schedule C - Jobs Credit, Tax Shelter Registration Requirement.
Schedule D - Gain from Form 4797, Schedule F Bartering Income.
Schedule E - Net Farm Rental Profit Loss.
Form 6251 - Foreign Tax Credit.
Form 6252 - Income Recapture F4797.
Form 8283 - Property Type - Art More than $20,000.

015 Schedule A - Other Miscellaneous Expense Type contain "CHILD CARE" or "MEDICAL" or CASUALTY" or "THEFT".

016-019 Reserved.

020 Name Line 1 (SEQ_060) of Form 1040 record is not present, or is in invalid format.

021 Name Line 2 (SEQ_070) of Form 1040 record is in invalid format.

022 State Code (SEQ_087) is not present, or is not equal to any of the valid State Code abbreviations.

023 City (SEQ_083) is not present.

024-029 Reserved

Attachment XIV (cont. 2)

Reject Codes and Explanations

030	Return record is not in sequence of Form 1040, schedules in ascending alpha sequence, forms in ascending numeric sequence, statement, and Summary Record; or pages within any of the forms and schedules are not consecutive and sequential.
031	Number of Logical Records in Tax Return of Summary Record does not equal generated Total Logical Record Count.
032	Schedule C page count is not equal to Total Pages of Schedules C in the Summary Record.
033	Schedule SE page count is not equal to Total pages of Schedules SE in the Summary Record.
034	Form 2106 page count is not equal to Total Pages of Forms 2106 in the Summary Record.
035	Form 4562 page count is not equal to Total Pages of Forms 4562 in the Summary Record.
036	Form 6198 page count is not equal to Pages of Forms 6198 in the Summary record.
037	Form 6252 page count is not equal to Total Pages of Forms 6252 in the Summary Record.
038	Form 8582 page count is not equal to Total Pages of Form 8582 in the Summary Record.
039	Form W-2 page count is not equal to Pages of Forms W-2 in the Summary Record.
040	Form W-2G page count is not equal to Pages of Forms W-2G in the Summary Record.
041	Form W-2P page count is not equal to Pages of Forms W-2P in the Summary Record.
042	Generated Total Schedule Records count is not equal to Number of Schedule Records in the Summary Record.
043	Generated Total Forms Records count is not equal to Number of Form Records in the Summary Record.
044	Generated Total Statement Records count is not equal to Number of Statement Records in the Summary Record.

Attachment XIV (cont.3)

Reject Codes and Explanations

045	There are more than three Schedules C; three rental properties on Schedule E; two Schedules SE; twenty Forms W-2; thirty Forms W-2G; ten Forms W-2P; one Form 2119; two Forms 2106; three Forms 4562; three Forms 6198; three Forms 6252; one Form 8582; two Forms 8606; or one of any other Schedule or Form not specified above.
046	SSN of first Schedule SE is not equal to Primary SSN or Spouse SSN (2 Schedules SE Present).
047	SSN of second Schedule SE is not equal to Primary SSN or Spouse SSN or is equal to SSN of first Schedule SE (2 Schedules SE present).
048	SSN of first Form 2106 is not equal to Primary SSN or Spouse SSN (2 Forms 2106 present)
049	SSN of second Form 2106 is not equal to Primary SSN or Spouse SSN or is equal to SSN of first Form 2106 (2 Forms 2106 present).
050	Required Statement field does not contain "STMbnn" or there is no corresponding Statement Record containing "STMbnn" in its Record ID).
051	There is no corresponding Statement Record for a Statement Reference.
053	Number of Actual Statements does not equal Number of Allowable Statements Referenced in the Tax Return Record.
054	Form 8606 Page Count is not equal to Pages of Forms 8606 in the Summmary Record.
055	IRA SSN of First Form 8606 is not equal to Primary SSN or Spouse SSN (2 Forms 8606 present).
056	IRA SSN of second Form 8606 is not equal to Primary SSN or Spouse SSN or is equal to IRA SSN of first Form 8606 (2 Forms 8606 present).

Reject Codes and Explanations

057-059 Reserved

060 Return Sequence Number is not greater than any preceding Return Sequence Number within the transmission.

061 Declaration Control Number is not greater than any preceding Declaration Control Number within the transmission.

062-069 Reserved

070 Spouse SSN is not numeric or "NRA".

071 Spouse SSN is equal to Primary SSN, or
Spouse SSN is less than 001010000, or
Spouse SSN is all nines, or
(Spouse SSN is equal to or greater than 627000000, and
Spouse SSN is equal to or less than 699999999), or
(Spouse SSN is equal to or greater than 729000000, and
Spouse SSN is equal to or less than 899999999).

072 Filing Status equals "4" and (Qualifying Name for Head of Household or Number or Name of Chidren at Home is not present) or (Qualifying Name for Head of Household or Number or Name of Children Not at Home is not present).

073 Filing Status equals "5" and Year Spouse Died is not equal to "85" or "86".

074 Reserved

075 EIC is significant and no Forms W-2, or no Forms W-2p with Disability Indicator set to "X", nor other earned income sources from any Schedule C, nor any Schedule E Partnership indicated, nor Other Income on Form 1040.

076 Interest Income of Form 1040 is greater than $400 and is not equal to Taxable Interest of Schedule B.

077 Tax Dividends of Forms 1040 is greater than $400 and is not equal to Taxable Dividends of Schedule B.

078 Cap Gain/Loss of Form 1040 Record is significant and not equal to Schedule D Gain or Schedule D Loss.

079 Rental Profit/Loss of Form 1040 is present and not equal to Total Income/Loss or Net Profit/Loss of Schedule E.

080 Moving Expenses of Schedule A is sigificant and not equal to Moving Expense Deduction of Form 3903.

Attachment XIV (cont. 5)

Reject Codes and Explanations

081 Form 1040 Schedule D Tax Indicator is equal to "X" and the Tentative Tax of Form 1040 is not equal to Schedule D Tax.

082 Total Itemized of Form 1040 is significant and not equal to Total Itemized Schedule A.

083 Credit for Child and Dependent of Form 1040 is significant and not equal to Credit for Child and Dependent "Line 6 Plus Line 7" of Form 2441.

084 Credit for Elderly or Disabled of Form 1040 is significant and not equal to Credit of Schedule R.

085 Schedule R is present and Taxable Disablilty is not significant and one of the following fields contains "X":
  Retired/Disabled
  Both Under 65, One Retired
  Both Under 65, Both Retired
  One Over 65, Other Retired
  Under 65, Did Not Live With Spouse

086 Self Employment Tax of Form 1040 is significant and not equal to Self Employment Tax of Schedule SE, or total if 2 Schedules SE are present.

087 Alternative Minimum Tax of Form 1040 is not equal to Alternative Minimun Tax of Form 6251.

088 Overpaid Amount of Form 1040 is not equal to Refund Amount plus Amount Applied to Estimated Tax.

089 Alimony Paid of Form 1040 is significant and Alimony SSN is not present or Alimony SSN is present and Alimony Paid of Form 1040 is not significant, or Alimony SSN is not in valid range, or is equal to Primary SSN.

090 Gain Taxable This Year of Form 2119 is significant and not equal to Residence Short Gain of Schedule D or Residence Long Term Gain of Schedule D of Form 6252 is not present.

091 Exculsion Amount of Form 2119 is significant and all of the following conditions are not met:
  Self 55 or Over Yes or Spouse 55 or Over Yes is "X"
  Lifetime Exclusion Yes or Lifetime Exclusion No is "X"
  Principal Residence Yes is "X"

Reject Codes and Explanations

092 Exclusion Amount of Form 2119 is significant and Filing Status is 2 or 3 and (Spouse 55 or Over Yes and Spouse 55 or Over No are both blank) and (Owner Residence You and Owner Residence Spouse Owner Residence Both are all blank).

093 Exclusion Amount of Form 2119 is significant and Filing Status is 3 and Spouse Consent Indicator is not "SC".

094 The sum of Installment Sale Short Term Gain plus Installment Sales Long Term Gain (Schedule D) is not equal to the Total Form 6252 Installment Sale Gain (sum of Line 23 plus Line 31).

095 Total Expenses Incurred (Seq #40) of Form 2441 is significant and (Primary Earned Income of Form 2441 is Not Greater than zero or Filing Status is 2 and Spouses Income of Form 2441 is not greater than zero).

096 Capital Gains of Schedule B is significant and (Schedule D Capital Gain Distribution and Capital Gain of Form 1040 are both blank).

097 Reserved

098 Gross Receipts minus Returns and Allowances does not equal the amount on Line 1(c) (Schedule C Income Balance).

099 Business Income or Loss of Form 1040 is not equal to the sum of Net Profit (Loss) (SEQ_710) fields of all Schedules C.

100-102 Reserved

103 Withholding of Form 1040 is greater than zero and a Form W-2 is not present and 1099/1099R Ind of Form 1040 is not "FORMb1099" or there is no significant entry for Withheld Tax on any Form W-2, Form W-2G or Form W-2P.

104 One or more of the Direct Deposit fields of Form 1040 do not match the Direct Deposit fields in the Summary Record.

105 Direct Deposit fields are significant in the Form 1040 or Summary Record but not in both, or if any Direct Deposit fields are significant but all Direct Deposit fields are not significant.

106-108 Reserved

109 Ownership Indicator of Form 1040 record is "0" and Filing Status is not 1, 3, 4 or 5.

Attachment XIV (cont. 7)

Reject Codes and Explanations

110 Ownership Indicator of Form 1040 record is "1" or "2" and Filing Status is not 2.

111 Ownership Indicator of Form 1040 record is "3" and Filing Status is not 2 or 3.

112-119 Reserved

120 Reimbursed Employee Business Expense of Form 1040 is significant and does not equal the Total Reimbursed Travel Expenses of Form 2106 nor does not equal the sum of Total Reimbursed Employee Expenses of Form 2106.

121 Unreimbursed Employee Business Expense of Schedule A is significant and does not equal the Unreimbursed Travel Expenses of Form 2106 nor equals the Total Unreimbursed Employee Business Expenses of Form 2106.

122 Reserved

123 Form W-2 Employer Identification Number and Employer Name are both missing.

124 Form W-2G Payer Name and Payer Identification Number are both missing.

125 Form W-2P Payer Name and Payer Identification Number are both missing.

126 On a Paid Preparer tax return, the Paid Preparer SSN and Preparer Firms EIN are absent from the Summary Record or either the Paid Preparers SSN or Preparers Firm EIN are invalid.

127-799 Reserved

800 Transmitter Record of the Transmission Data is not in the specified format.

801-819 Reserved

820 Generated when the Julian Date contained in the Electronic Transmission ID Data is more than two days prior to the Julian Date of the actual Process Date, or more than one day after the Julian Date of the actual Process date.

821 Transmitter ID Number is invalid.

822 Duplicate Transmission.

Attachment XIV (cont. 8)

Reject Codes and Explanations

823-824 Reserved.

825 Transmission Data is not in the proper sequence of Transmitter Record, and Recap Transmission Record.

826-829 Reserved

830 Total Computed EFT Count does not match the Total EFT Count in the Recap Transmission Record.

831 Total Computed Return Count does not match the Total Return Count in the Recap Transmission Record.

832 Total Computed Overpaid Returns Count does not match the Total Overpaid Returns Count in the Recap Transmission Record.

833-839 Reserved

840 The Recap Record is not in the specified format.

841-899 Reserved

900 A duplicate tax return record previously processed in the current tax year as an accepted electronically filed return.

901 EFT data on the tax return previously processed as accepted EFT data for the current processing year through the Electronic Filing System.

902-998 Reserved

999 More than ten errors on this return record.

Attachment XV

Street Address Abbreviations

Word	Abbreviation
and	&
Air Force Base	AFB
Apartment	APT
Avenue	AVE
Boulevard	BLVD
Building	BLDG
Care of, or In care of	%
Circle	CL
Court	CT
Drive	DR
East	E
General Delivery	GEN DEL
Highway	HWY
Lane	LN
North	N
Northeast, N.E.	NE
Northwest, N.W.	NW
One-Half	1/2 (all fractions, space before & after the number, i.e., 1012 1/2 ST)
Parkway	PKY
Place	PL
Post Office Box, P.O. Box	PO BOX
Route, Rte.	RT
Road	RD
R.D., Rural Delivery, RFD, R.F.D., R.R., Rural Route	R D
South	S
Southeast, S.E.	SE
Southwest, S.W.	SW
Street	ST
Terrace	TER
West	W

Attachment XVI

Standard Postal Service State Abbreviations

State	Abbrev.	Zip Code	State	Abbrev.	Zip Code
Alabama	AL	350-369	Mississippi	MS	386-397
Alaska	AK	995-999	Missouri	MO	630-658
Arizona	AZ	850-865	Montana	MT	590-599
Arkansas	AR	716-729	Nebraska	NE	680-693
		& 755	Nevada	NV	890-898
California	CA	900-966	New Hampshire	NH	030-038
Colorado	CO	800-816	New Jersey	NJ	070-089
Connecticut	CT	060-069	New Mexico	NM	870-884
Delaware	DE	196-199	New York	NY	090-149
District of			North Carolina	NC	270-289
Columbia	DC	200-205	North Dakota	ND	580-588
Florida	FL	320-340	Ohio	OH	430-458
		& 392	Oklahoma	OK	730-749
Georgia	GA	300-319	Oregon	OR	970-979
Hawaii	HI	967-968	Pennsylvania	PA	150-196
Idaho	ID	832-838	Rhode Island	RI	028-029
Illinois	IL	600-629	South Carolina	SC	290-299
Indiana	IN	460-479	South Dakota	SD	570-577
Iowa	IA	500-528	Tennessee	TN	370-385
Kansas	KS	600-679	Texas	TX	750-799
Kentucky	KY	400-427	Utah	UT	840-847
Louisiana	LA	700-714	Vermont	VT	050-059
Maine	ME	039-049	Virginia	VA	220-246
Maryland	MD	206-219	Washington	WA	980-994
Massachusetts	MA	010-027	West Virginia	WV	247-268
Michigan	MI	480-499	Wisconsin	WI	530-549
Minnesota	MN	550-567	Wyoming	WY	820-831

26 CFR 601.104: Collection functions.

Rev. Proc. 88-21

SECTION 1. PURPOSE

This revenue procedure provides guidance under section 1446 of the Internal Revenue Code concerning certain withholding requirements applicable to distributions by partnerships with foreign partners. This revenue procedure provides general guidance on how to comply with section 1446, and provides for an election permitting quarterly payments of tax based on effectively connected income of a foreign partner, in lieu of withholding on distributions.

SEC. 2. BACKGROUND

Section 1446 of the Code generally applies to U.S. and foreign partnerships that have income effectively connected with the conduct of a U.S. trade or business ("effectively connected income"). Such partnerships must withhold tax when they make a distribution to a partner that is a foreign person. Under the election provided for by this revenue procedure, such partnerships may instead make quarterly payments of tax at specified rates based on the amount of effectively connected income of the partnership that is includible in the taxable income of each foreign partner. Accordingly, this revenue procedure provides guidance concerning the following matters:

(a) Description of withholding requirements under section 1446 (Section 3—REQUIREMENT OF WITHHOLDING);

(b) Who is responsible for withholding under section 1446 (Section 4—WITHHOLDING AGENTS);

(c) How to determine whether a partner is a foreign person subject to withholding (Section 5—DETERMINATION OF FOREIGN STATUS);

(d) Which partnership distributions are subject to withholding (Section 6—SECTION 1446 DISTRIBUTIONS);

(e) How much of a partnership distribution is subject to withholding (Section 7—EFFECTIVELY CONNECTED PERCENTAGE);

(f) Partnership election to make quarterly payments of tax on the basis of foreign partners' effectively connected income attributable to the partnership (Section 8—ELECTION BY PARTNERSHIP);

(g) How to report and pay over withheld amounts or quarterly payments (Section 9—REPORTING AND PAYING OVER OF WITHHELD AMOUNTS OR QUARTERLY PAYMENTS);

(h) How to claim a credit for taxes withheld or quarterly payments (Section 10—CREDITABILITY OF WITHHELD AMOUNTS OR QUARTERLY PAYMENTS);

(i) Partnerships exempt from withholding under section 1446 (Section 11—EXEMPT PARTNERSHIPS);

(j) Special rules for publicly traded partnerships (Section 12—PUBLICLY TRADED PARTNERSHIPS); and

(k) Special rules for tiered partnerships (Section 13—TIERED PARTNERSHIPS).

SEC. 3. REQUIREMENT OF WITHHOLDING

If at any time after December 31, 1987 a foreign or domestic partnership has income, gain, or loss effectively connected with the conduct of a U.S. trade or business, then the partnership or a withholding agent for that partnership must withhold a tax of 20 percent with respect to the effectively connected percentage of any section 1446 distribution made on or after January 1, 1988, by the partnership to any partner that is a foreign person. Tax withheld must generally be paid over to the Internal Revenue Service by the 20th day following the date of the distribution. However, tax withheld shall in no event be paid over to the Service before June 15, 1988.

If a partnership has made the election described in Section 8 of this revenue procedure, the partnership or a withholding agent for the partnership shall instead make quarterly payments of tax at rates specified with respect to the effectively connected income of each foreign partner attributable to the partnership, in accordance with the rules set forth in Sections 8 and 9. In the case of partnerships that make the election described in Section 8 by June 15, 1988, any amounts withheld from distributions made before June 15, 1988, may be used to make the quarterly payments of tax due under the election.

SEC. 4. WITHHOLDING AGENTS

.01 *In general.* If distributions from a partnership are subject to withholding under section 1446 of the Code then the partnership or a withholding agent for the partnership must withhold or make quarterly payments of tax under the election described in Section 8 of this revenue procedure. The general partners of a partnership shall be jointly and severally liable as withholding agents for the partnership. In addition, the term withholding agent shall also include any other person who pays or causes to be paid a distribution to a foreign person (or to an agent of a foreign person) under the principles of section 1441(a) and section 1.1441-7(a) of the Income Tax regulations. For ease of reference, this revenue procedure refers to various requirements applicable to withholding agents as requirements applicable to partnerships themselves. This does not affect the legal incidence of liability. For special rules concerning withholding agents of publicly traded partnerships, see Section 12 of this revenue procedure.

.02 *Penalty for failure to withhold.* A partnership required to deduct and withhold tax under section 1446 of the Code is made liable under section 1461 for that tax, or for a tax equal to all payments required to be made under the election described in Section 8 of this revenue procedure. Therefore, a partnership that is required to deduct and withhold tax or make quarterly payments of tax, but fails to do so, may be held liable for the payment of tax, any applicable penalties, and interest. A person failing to withhold or make quarterly payments of tax required by section 1446 may also be subject to civil and criminal penalties. Officers or other responsible persons of either a corporation that is a general partner or any other withholding agent may be subject to a civil penalty under section 6672 equal to the amount that should have been withheld from distributions and paid over or paid quarterly under the election provided in Section 8.

Partnerships that are required to withhold tax on section 1446 distributions but fail to do so shall be required to pay interest under the principles of section 1.1445-1(e) of the regulations on the amount of tax that should have been withheld and paid over. Interest is generally payable by the partnership for the period beginning on the 21st day following the date of the section 1446 distribution and ending on the date the tax is actually paid to the Internal Revenue Service. However, in the case of a failure to withhold and pay over the tax required to be withheld a section 1446 distribution made on or before June 15, 1988, interest shall be imposed beginning on the later of June 16, 1988, or the 21st day following the date of the section 1446 distribution.

A partnership that has made the election described in Section 8 of this revenue procedure, but fails to make a quarterly payment when due, shall be required to pay an additional amount beginning on the day after the due date provided in this revenue procedure for the quarterly payment. This additional amount shall be equal to the penalty imposed under section 6655 of the Code on an underpayment of estimated tax, and shall be imposed without regard to whether the partner is taxable as a corporation.

SEC. 5. DETERMINATION OF WHETHER A PARTNER IS A FOREIGN PERSON

.01 *In general.* Section 1446 of the Code requires withholding with respect to any partner that is a foreign person. Accordingly, a partnership must determine under the rules of this Section whether any partner is a foreign person subject to section 1446. For purposes of section 1446, a foreign person is a nonresident alien individual, foreign corporation, foreign partnership, or foreign trust or estate. A partnership may determine a partner's status by relying upon a certification of non-foreign status, under the rules of Section 5.02 of this revenue procedure, or any other means, under the rules of Section 5.03.

.02 *Certification of non-foreign status.*

1 *In general.* This Section provides rules pursuant to which a partnership can determine that a partner is not a foreign person by obtaining a certification of non-foreign status from the partner. A partnership that has obtained such a certification may rely upon it to establish the non-foreign status of a partner, as provided in paragraph 2, below.

2 *Reliance upon certification.* A partnership that has obtained a certification of non-foreign status in accordance with the rules of this Section may rely upon the certification to determine that the partner is not subject to withholding, but only if the partnership does not have actual knowledge that the certification is false. If a partnership relies in good faith upon a certification, but it is subsequently determined that the certification was false, the partnership shall not be subject to the liability imposed by Section 4.02 of this revenue procedure for a failure to withhold under section 1446 of the Code. A partnership may rely on a partner's certification of non-foreign status until the earliest of—

(a) the end of the third year after the taxable year of the partnership during which the certification was obtained;

(b) the time the partnership receives notice from the partner that it has become a foreign person; or

(c) the time the partnership has actual knowledge that the partner is, or has become, a foreign person.

If a partnership has actual knowledge that a certification of non-foreign status is false, it shall not be entitled to rely on that certification at any time after obtaining that knowledge, and the partnership shall be fully liable under section 1461 for any failure to withhold or make a quarterly payment of tax as of the time it obtained that knowledge. A certification that satisfies the requirements of this revenue procedure will also satisfy the requirements for a withholding certificate under section 1445.

3 *Certification.* No particular form is required for a certification of non-foreign status, nor is any particular language required. The certification must—

(a) State that the partner is not a foreign person,

(b) Set forth the partner's name, U.S. taxpayer identifying number, and home address (in the case of an individual) or office address (in the case of an entity),

(c) Provide that the partner will notify the partnership within sixty (60) days of a change to foreign status, and

(d) Be signed under penalties of perjury.

An individual's identifying number is the individual's social security number (or such other taxpayer identification number as may have been assigned to a foreign individual by the Internal Revenue Service), and any other person's identifying number is its U.S. employer identification number. A certification of non-foreign status must be verified as true and signed under penalties of perjury by a responsible corporate officer in the case of a corporation, by a general partner in the case of a partnership, and by a trustee, executor, or equivalent fiduciary in the case of a trust or estate. A certification of non-foreign status may also be signed by a person authorized under a power of attorney in proper form executed by the partner, provided the power of attorney accompanies the certification. Examples of acceptable certifications of non-foreign status are provided in Section 5.04 of this revenue procedure.

4 *Retention of certifications.* A partnership must retain a certification of non-foreign status until the end of the fifth taxable year after the last taxable year in which the partnership relied upon the certification.

5 *Certifications under section 1445.* For purposes of section 1446 of the Code, a partnership may rely on a certification of non-foreign status provided by a partner under section 1445 and section 1.1445-2 or -5 of the regulations until the beginning of the partnership's first taxable year beginning after 1988. However, a partnership may not rely upon a certification of non-foreign status given by a foreign corporation that has based the certification on an election under section 897(i). A foreign corporation that has made an election under section 897(i) continues to be treated as a foreign person for all U.S. tax purposes other than sections 897, 1445, and 6039C. Thus, a distribution to such a foreign corporate partner is subject to withholding under section 1446 notwithstanding the election under section 897(i).

6 *Special rule for widely held partnerships.* A partnership that is widely held, as defined in this paragraph, may rely on statements provided to it on Form 1001, Form W-8, or Form W-9 to determine whether a partner is a foreign person, or on a certification from a nominee that a partner owning a partnership interest through the nominee is not a foreign person. For this purpose a nominee may in turn rely on a certification of non-foreign status provided by a foreign partner under the rules of Section 5.02 of this revenue procedure, or may rely on statements provided to it on Form 1001, Form W-8, or Form W-9 to determine whether a partner is a foreign person. A partnership is widely held for purposes of this paragraph if it has more than 200 partners (other than a regularly traded partnership within the meaning of section 1.1445-8T of the regulations subject to the rules in Section 12) on the date it is or may be required to withhold on a section 1446 distribution or make a quarterly payment under the election described in Section 8.

.03 *Use of means other than certification.* A partnership is not required to obtain a certification of non-foreign status under the rules of Section 5.02 of this revenue procedure; a partnership may instead rely upon other means to ascertain the non-foreign status of the partner. If, however, the partnership relies upon other means and erroneously determines that the partner was not a foreign person, then the partnership is subject to the liability described in Section 4.02. A partnership is in no event required to rely upon other means to determine the non-foreign status of a partner and may demand a certification of non-foreign status. If a certification is not provided, the partnership may withhold tax under section 1446 of the Code and will be considered, for purposes of sections 1461 through 1463, to have been required to withhold such tax.

.04 *Sample certifications.* The following are examples of acceptable certifications under the rules of this revenue procedure.

(a) *Partners who are individuals.* "Section 1446 of the Internal Revenue Code provides that a partnership must withhold a tax equal to 20 percent of any section 1446 partnership distribution, if the partner is a foreign person. To inform [name of partnership] that the provisions of section 1446 do not apply, I, [name of partner], hereby certify the following:

1. I am not a nonresident alien for purposes of U.S. income taxation;
2. My U.S. taxpayer identification number (social security number) is __________ ; and
3. My home address is ______ .

I hereby agree that if I become a nonresident alien, I will notify the partnership within sixty (60) days of doing so. I understand that this certification may be disclosed to the Internal Revenue Service by the partnership and that any false statement I have made here could be punished by fine, imprisonment, or both.

Under penalties of perjury I declare that I have examined this certification and to the best of my knowledge and belief it is true, correct and complete.

[Signature and Date]"

(b) *Partners that are entities.* "Section 1446 of the Internal Revenue Code provides that a partnership must withhold a tax equal to 20 percent of any section 1446 partnership distribution if the partner is a foreign person. To inform [name of partnership] that the provisions of section 1446 do not apply, the undersigned hereby certifies on behalf of [name of the entity] the following:

1. [Name of the entity] is not a foreign corporation, foreign partnership, foreign trust, or foreign estate (as those terms are defined in the Internal Revenue Code and Income Tax Regulations);
2. [Name of the entity]'s U.S. employer identification number is __________ ; and
3. [Name of the entity]'s office address is __________ .

[Name of the entity] hereby agrees to notify the partnership within sixty (60) days of the date [name of the entity] becomes a foreign person. [Name of entity] understands that this certification may be disclosed to the Internal Revenue Service by the partnership and that any false statement contained herein could be punished by fine, imprisonment, or both.

Under penalties of perjury I declare that I have examined this certification and to the best of my knowledge and belief it is true, correct, and complete, and I further declare that I have authority to sign this document on behalf of [name of entity].

[Signature and Date]
[Title]"

SEC. 6. SECTION 1446 DISTRIBUTIONS

.01 *In general.* A foreign or domestic partnership must withhold with respect to any section 1446 distribution to a foreign partner. A section 1446 distribution consists of any actual distribution of money or property, and certain constructive distributions arising from the assumption of liabilities, as described in item (c) below. If an actual distribution is made with property other than money, the partnership shall not release the property until it has funds sufficient to enable the partnership to pay over in money the tax required to be withheld. The amount of a section 1446 distribution includes the amount of any tax required to be withheld with respect to that distribution, and must be calculated under the rules set forth below. Except as provided herein, a section 1446 distribution consists of—

(a) the gross amount of money actually distributed (prior to withholding of tax under section 1446);

(b) 125 percent of the fair market value of any property other than money actually distributed; and

(c) 125 percent of the amount of (i) any individual liability of a foreign partner that is assumed by the partnership, and (ii) any liability encumbering property that a foreign partner contributes to the partnership.

The 125 percent figure used in items (b) and (c) takes into account the fact that the section 1446 tax paid on the distribution of property (or assumption of a liability) itself constitutes a distribution by the partnership for the benefit of the partner, subject to withholding under section 1446. In such a case the total section 1446 distribution algebraically equals 125 percent of the fair market value of property distributed (or liability assumed).

.02 *Excluded amounts.* Distributions from partnerships are deemed to be paid first out of the following types of income in the order indicated and are excluded from the term "section 1446 distribution" to the extent thereof;

1. Amounts attributable to noneffectively connected income distributed by a partnership that have been or are subject to the withholding requirements of section 1441 or 1442 of the Code (without regard to whether any amount was or is required to be withheld because of a treaty or statutory exemption); and

2. Amounts that are attributable to the disposition of a U.S. real property interest and that have been, or are, subjected to the withholding requirements of the regulations under section 1445 (without regard to whether any amount was or is required to be withheld), subject to the rule of Section 6.03 of this revenue procedure.

.03 *Coordination with section 1445.* Notwithstanding the provisions of Section 6.02 of this revenue procedure, section 1446 distributions shall include—

(a) The fair market value of a U.S. real property interest distributed to a partner and potentially subject to withholding under section 1445(e)(4) of the Code, regardless of whether amounts are in fact withheld under section 1445; and

(b) Amounts not subject to withholding under section 1445 because the distributee is a foreign corporation that has made an election under section 897(i)).

SEC. 7. EFFECTIVELY CONNECTED PERCENTAGE

.01 *In general.* The portion of a section 1446 distribution that is subject to withholding may be affected by the percentage of the partnership's income that is effectively connected with the conduct of a U.S. trade or business. Partnerships must withhold on the entire amount of a section 1446 distribution when the effectively connected percentage of the partnership is 80 percent or greater. When a partnership's effectively connected percentage is less than 80 percent, the partnership must withhold on only the effectively connected percentage of a section 1446 distribution.

.02 *Computation of the effectively connected percentage.* The effectively connected percentage is equal to a fraction, the numerator of which is the amount of the partnership's gross income from all sources during the measuring period that is effectively connected with the conduct of a trade or business within the United States (under section 864 of the Code and section 1.864-3 of the regulations), and the denominator of which is the amount of the partnership's gross income from all sources during the measuring period. However, in determining the effectively connected percentage, neither the numerator nor the denominator of the fraction shall include amounts of noneffectively connected income that were received during the measuring period but excludable from the amount of a section 1446 distribution under Section 6.02 of this revenue procedure.

.03 *Measuring period.* The measuring period for the effectively connected percentage consists of the three taxable years preceding the taxable year in which a partnership makes a section 1446 distribution, or such part of that three year period as the partnership has been carrying on a trade or business in the United States within the meaning of section 1.6031-1 of the regulations (relating to the duty to file partnership returns).

SEC. 8. ELECTION BY PARTNERSHIP TO MAKE QUARTERLY PAYMENTS OF TAX ON THE BASIS OF FOREIGN PARTNER'S EFFECTIVELY CONNECTED INCOME ATTRIBUTABLE TO THE PARTNERSHIP INSTEAD OF WITHHOLDING ON ACTUAL DISTRIBUTIONS

.01 *In general.* Withholding under section 1446 of the Code shall not be required on section 1446 distributions to a foreign partner if the partnership makes an election to instead make quarterly payments of tax at the rates specified in Section 8.025 of this revenue procedure, *infra*, for each foreign partner based on the foreign partner's effectively connected taxable income attributable to the partnership ("the ECI election") in accordance with the rules of this Section.

A partnership that makes an ECI election must retain and pay over, as set forth below, an amount based on each foreign partner's effectively connected taxable income attributable to the partnership. Because amounts may be required to be paid over under an ECI election at a time other than the time of an actual distribution, a partnership that makes such an election must exercise care to retain funds adequate to meet its obligations under the election.

.02 *Calculation of quarterly payments of tax.*

1 *In general.* A partnership that has made the ECI election must make quarterly payments of tax at the appropriate rate specified in Section 8.025 of this revenue procedure, based on the effectively connected income of each foreign partner attributable to the partnership for the partner's current year. Thus, the partnership must estimate each foreign partner's effectively connected income attributable to the partnership for the partner's taxable year, and make quarterly payments equal to 25 percent of that estimate multiplied by the appropriate tax rate specified in Section 8.025. A partner's liability for the tax imposed under section 884 of the Code and the partner's distributive share of the partnership's tax credits shall not be taken into account in determining the amount of the partner's quarterly payments. Certain timing issues may be presented because a partner may have a different taxable year than its partnership; these issues are addressed in Section 8.03, below.

2. *Coordination with estimated tax liability.* Amounts paid under the ECI election shall be credited against the estimated tax liability of the foreign partner.

3 *Partner's effectively connected income.* For purposes of calculating quarterly payments of tax under the ECI election, a foreign partner's effectively connected income is the distributive share of gross effectively connected income of the partnership for the taxable year of the partnership ending within the partner's taxable year that is properly allocable to the partner under section 704 of the Code, reduced by the distributive share of deductions of the partnership for such year that are properly allocable to the partner under section 704 and connected with such income under section 873 or section 882(c)(1).

4 *Partnership's effectively connected income.* For purposes of the ECI election, a partnership's gross effectively connected income is based upon the income derived by the partnership that is effectively connected with the conduct of a U.S. trade or business during the partnership's relevant taxable year, as determined under section 864 of the Code and the regulations thereunder, and generally includes the sum of all items of income set forth in section 702(a), to the extent determined to be effectively connected. However, net operating losses and charitable contributions shall not be taken into account in determining a partnership's effectively connected income for this purpose. For purposes of the ECI election, the effectively connected income of a partnership includes income subject to a partner's election under section 871(d) or 882(d) of the Code, and also includes any amount treated as effectively connected with the conduct of a U.S. trade or business pursuant to section 897.

5 *Tax rate.* The amount required to be paid by a partnership under the ECI election with respect to a foreign partner shall be determined by multiplying the foreign partner's effectively connected income attributable to the partnership, as determined under paragraph 3 of this Section, by the applicable tax rate. In the case of a foreign partner that is not taxable as a corporation, the tax rate is the highest rate of tax specified in section 1 of the Code (28% for taxable years beginning in 1988). In the case of a foreign partner that is taxable as a corporation, the tax rate is the highest rate of tax specified in section 11(b) (34% for taxable years beginning in 1988). If a partner is itself a partnership, or if it cannot be determined whether or not a foreign partner is taxable as a corporation, the applicable tax rate shall be the maximum rate specified in section 11(b).

.03 *Timing of ECI quarterly payment.*

1 *In general.* Under the ECI election, the payments of tax for a foreign partner must be made no later than the estimated tax payment dates for that foreign partner. Estimated tax payment dates for a corporation are the 15th day of the fourth, sixth, ninth, and twelfth months of its taxable year. However, in the case of foreign partners that are individuals, four quarterly payments must be made under the ECI election, notwithstanding section 6654(j) of the Code which requires only three payments of estimated tax by a nonresident alien partner described in section 6072(c). For example, in the case of individual foreign partners who have a calendar taxable year, quarterly amounts must be paid over by April 15, June 15, September 15, and January 15 of the following year. The partnership shall assume that all foreign partners have a calendar taxable year unless the partnership is notified by the partner of the partner's fiscal taxable year.

2 *Transition rule for 1988.* The first quarterly payment in 1988 shall not be due before June 15, 1988. In the case of a calendar year partner, for its 1988 calendar year only three quarterly payments shall be due, and the amount due as the partner's first payment by June 15, 1988, shall be the sum of the amount that would otherwise have been due on April 15, 1988 and June 15, 1988 if four quarterly payments had been required in 1988 for such a partner. In the case of a partner with a fiscal taxable year (*i.e.*, a year that does not end on December 31), the amount of the quarterly payment due to be paid to the Internal Revenue Service on June 15, 1988, shall be the sum of all payments that the partnership would otherwise be required to make after December 31, 1987, but on or before June 15, 1988, on behalf of the partner. All subsequent quarterly payments for that partner are due on the date subsequent estimated tax payments for the partner are due.

3 *Partnership income to be taken into account.* The amount required to be paid on a quarterly basis under the ECI election is based on partnership income includible by the partner in the partner's taxable year to which an estimated tax payment on that date by a U.S. resident would relate. Accordingly, if the partner and the partnership are both calendar year taxpayers, the amount to be paid for each quarter of the partner must be calculated by reference to the income of the current taxable year of the partnership (except that the January 15 payment for an individual partner is based on the income of the partnership for the year that ended on the immediately preceding December 31). However, if the partner and partnership have non-conforming taxable years, the partnership income to be taken into account in making quarterly payments for the partner under the ECI election will relate to the taxable year of the partnership that ends within the relevant taxable year of the partner.

.04 *Correction of estimates and safe harbor.*

1 *In general.* If amounts paid over by the partnership in prior quarters for the same taxable year under the ECI election are greater or less than the amount necessary based on current estimates of partnership income, then appropriate adjustments may be made to the amount of subsequent payments of tax.

2 *Safe harbor.* The principles of section 6654(d)(1) and 6655(d) of the Code shall be applied in determining whether the quarterly payments for the current taxable year of the partnership made by the partnership for individual and corporate foreign partners, respectively, are greater or less than the amount necessary. In the case of quarterly payments for a foreign corporate partner that satisfies the definition of a large corporation in section 6655(i)(2) based upon its distributive share of a partnership's effectively connected taxable income, the principles of section 6655(i) shall be applied in determining whether the quarterly payments are greater or less than the amount necessary. The partner's distributive share of the partnership's effectively connected taxable income for the preceding taxable year of the partnership, shall be used when applying the principles of section 6654(d)(1) and 6655. However, the preceding taxable year of the partnership shall not be used with respect to any quarterly payment made after the date specified in section 6031(b) on which the partnership must report to its partners the partnership's tax return information; in this situation the amount of the quarterly payment must be based on the taxable year of the partnership to which the payment actually relates.

2 *Transition rule.* Quarterly payments of tax for a partner that are made during 1988 under the ECI election are not to be adjusted under

paragraph .041 of this Section for prior quarters for which the estimated tax payment dates occurred prior to January 1, 1988.

3 *Examples.*

Example 1. If a partnership has a fiscal taxable year that begins on February 1, 1987, and ends on January 31, 1988, and an individual foreign partner has a calendar taxable year, the quarterly payments that must be made during the 1988 taxable year of the partner under the ECI election with respect to that partner must be based upon the income of the partnership's 1987-1988 taxable year, and the first quarterly payment by the partnership will be due on June 15, 1988.

Example 2. The facts are the same as in Example 1, except the individual foreign partner and the partnership both have a fiscal taxable year ending on January 31. In this situation, the partnership must make one quarterly payment in 1988 (on June 15, 1988 for the partner's February 15, 1988 quarterly payment date) with respect to that partner that is based upon the partnership's 1987-1988 taxable year. The amount of that payment will be the sum of two amounts. The first amount is equal to 25 percent of the tax liability of the foreign partner with respect to the effectively connected income attributable to the partnership's 1987-1988 taxable year, computed as provided in Section 8.02 of this revenue procedure (although the safe harbor rules in Section 8.042 may prevent the partnership from incurring liability to pay additional amounts if less than 25 percent is paid). The second amount reflected in the June 15, 1988 quarterly payment by the partnership will be equal to an amount based on the first payment of estimated tax due for the foreign partner on May 15, 1988, with respect to that partner's effectively connected income attributable to the partnership's 1988-1989 taxable year. The partner should adjust its subsequent estimated tax payments to the extent that it made an estimated tax payment on May 15, 1988 which was duplicated by the partnership in the partnership's June 15, 1988 payment.

.05 *Coordination with other withholding rules.*

1 *Interest, dividends, etc.* Fixed or determinable, annual or periodical income subject to tax only under section 871(a) or 881 of the Code is not included in the partnership's effectively connected taxable income under Section 8.02 of this revenue procedure for purposes of the ECI election. However, such amounts are independently subject to withholding pursuant to the requirements of sections 1441 and 1442 and the regulations thereunder.

2 *Real property gains.* A partnership that makes the ECI election shall be exempt from the requirements of section 1445(e) of the Code with respect to its dispositions of U.S. real property interests that occur during taxable years of the partnership during which the election is in effect.

.06 *Time, manner, and effective date of ECI election.*

1 *In general.* The ECI election shall be effective as of January 1, 1988. An election shall be deemed to have been made if the partnership makes quarterly payments of tax in accordance with the rules of this Section beginning on June 15, 1988. The ECI election shall apply to the taxable year of the partnership in which the election is made, and to all subsequent taxable years. An ECI election may be revoked only with the consent of the Commissioner.

2 *Retroactive ECI election.* A partnership that has not made an ECI election as of June 15, 1988, may nevertheless make such an election at any later date if the partnership pays over, together with interest imposed on underpayments of tax accrued thereon, all amounts that should have been withheld pursuant to the ECI election on and after January 1, 1988. In such case, amounts previously withheld and paid over with respect to section 1446 distributions may be credited against the amount required to be paid over pursuant to this paragraph.

SEC. 9. REPORTING AND PAYING OVER WITHHELD TAX

.01 *In general.* The tax withheld on a distribution under section 1446 of the Code must be reported and paid over to the Internal Revenue Service by the partnership by the 20th day following the distribution. Quarterly payments of tax due under the ECI election must be made by a partnership by the appropriate quarterly payment date described in Section 8.03 of this revenue procedure. However, no amounts shall be due before June 15, 1988.

Until a change is announced in a future administrative pronouncement by the Internal Revenue Service, the tax withheld on distributions and the quarterly payments of tax shall be:

(a) made payable to the Internal Revenue Service; and

(b) sent to the Internal Revenue Service, P.O. Box 21086, Philadelphia, PA 19114.

Until official Internal Revenue Service forms are available and obtained by a partnership, payments made to the Internal Revenue Service under section 1446 of the Code must be accompanied by the information prescribed in Section 9.02 and Section 9.03. Pursuant to Section 7502 and the regulations thereunder, the timely mailing of the tax withheld or the quarterly payment with the information specified in Section 9.02 and 9.03 shall be treated as timely filing.

.02 *Information required concerning distributing partnerships and withholding agent.* Payments to the Internal Revenue Service of amounts withheld from section 1446 distributions and quarterly payments of tax must be accompanied by an attachment in the format and order specified below. The attachment must contain the following heading and information:

Withholding on Income of Foreign Partners Under Section 1446—
WITHHOLDING AGENT

1(a). Withholding Agent's Name:
(b). Employer identification number:
(c). Address (number and street):
(d). City, State, and ZIP code (or equivalent):

2(a). Partnership's Name (if partnership is also the withholding agent, enter "SAME" and do not complete lines 2(b)—(d)):
(b). Employer identification number:
(c). Address (number and street):
(d). City, State, and ZIP code (or equivalent):

3. Partnership's taxable year end: (date)

4(a). Amount withheld from distributions at 20% rate and submitted with this form:
(b). Amount of quarterly payments at 28% rate submitted with this form:
(c). Amount of quarterly payments at 34% rate submitted with this form:
(d). Total amount paid with this form (add lines 4(a), 4(b), and 4(c)) (note that line 4(a) will always be 0 if the partnership makes the ECI election described in section 8 of this revenue procedure, and lines 4(b) and (c) will always be 0 if the partnership instead withholds on distributions):

[Complete item 5 only if partnership is withholding on distributions]

5(a). Number of partners subjected to withholding on distributions at 20% rate:
(b). Total amount of distributions subject to withholding:

[Complete items 6 and 7 only if partnership has made the ECI election.]

6(a). Number of individual partners for whom quarterly payments are being made at 28% rate:
(b). Total distributive share of partnership income allocable to these individual partners:

7(a). Number of partners for whom quarterly payments are being made at 34% rate:
(b). Total distributive share of partnership income allocable to these partners:

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true correct and complete. Declaration of preparer (other than withholding agent) is based on all information of which preparer has any knowledge.
Please Sign Here > ____________________________ Date: ___________

.03 *Information required to be reported for each foreign partner.* An attachment to the summary described above in Section 9.02 of this revenue procedure must be supplied for each foreign partner for whom tax is withheld or a quarterly payment of tax is made. The attachment must contain the following heading and information in the format and order specified:

Withholding on Income of Foreign Partners Under Section 1446—
FOREIGN PARTNER

1(a). Partner's name:
(b). Taxpayer identification number:
(c). Address (number and street):
(d). City, State, and ZIP code (or equivalent):

2(a). Type of partner (individual, corporation, partnership, other (specify)):
(b). Country code of Partner (see listing of codes in instructions for Form 1042S) and 1986-2 C.B. 709-711.

3(a). Withholding agent's name:
(b). Withholding agent's Employer Identification Number:

4(a). Partnership's name (if partnership is also withholding agent, enter "SAME" and do not complete line 4(b)):
(b). Partnership's Employer Identification Number:

Note: Complete item 5 only if partnership has elected to make quarterly payments on behalf of partner.

5(a). Date of quarterly payment:
(b). Taxable year of partner to which payment relates:
(c). Quarterly estimate of partnership effectively connected income allocable to partner:
(d). Applicable tax rate (maximum rate under either section 1, or section 11(b)):
(e). Total tax liability (line 5(c) times line 5(d)):
(f). Amount of section 1446 tax previously withheld on distributions to partnership and allocable to partner (to extent not previously used as credit by partnership):
(g). Amount of quarterly payments previously made on behalf of partnership and allocable to partner (to extent not previously used as credit by partnership):
(h). Total section 1446 payments previously made (line 5(f) plus line 5(g)):
(i). Quarterly payment due (line 5(e) minus line 5(h)):
(j). Tax creditable by partner (line 5(e)):

Note: **Complete item 6 only if partnership will withhold on distributions and will not elect to make quarterly payments of tax.**

6(a). Taxable year of partner to which payment relates:
(b). Date of distribution:
(c). Total amount distributed:
(d). Amount of section 1446 distribution:
(e). Effectively connected percentage (enter 100% if effectively connected percentage is greater than or equal to 80%):
(f). Amount subject to withholding (line 6(d) times line 6(e)):
(g). Total withholding liability (line 6(f) times 20%):
(h). Amount of section 1446 tax previously withheld on distributions to partnership and allocable to partner (to extent not previously used as credit by partnership):
(i). Amount of quarterly payments previously made on behalf of partnership and allocable to partner (to extent not previously used as credit by partnership):
(j). Total section 1446 payments previously made (line 6(h) plus line 6(i)):
(k). Withholding tax due (line 6(g) minus line 6(j)) (Note: enter 0 if line 6(j) is greater than or equal to line 6(g)):
(l). Tax creditable by partner (line 6(g)):

.04 *Reporting to partners.* A partnership must provide foreign partners with a copy of the statement that is described in Section 9.03 of this revenue procedure. This information must be supplied to foreign partners even if no tax is withheld or quarterly payments are made under section 1446 of the Code and a statement is not filed with the Internal Revenue Service. This information must be delivered to the foreign partner by the 30th day after the last date on which the relevant payment, if any, would be required to be made to the Internal Revenue Service.

.05 *Payment Without Identifying Number.* A partnership that has not been assigned a U.S. identifying number (an Employer Identification Number ("EIN")) must obtain one, and must in any event withhold and pay over any tax withheld, or quarterly payment, to the Internal Revenue Service, P.O. Box 21086, Philadelphia, PA 19114, by the time provided in this revenue procedure. Accompanying any payment must be a statement containing the relevant information described above in Section 9.02 and 9.03 and indicating the date the EIN was applied for. Upon receipt of its EIN, the partnership must immediately provide that number to the Internal Revenue Service, P.O. Box 21086, Philadelphia, PA 19114.

.06 *Taxpayer identification numbers of partners.* To assure appropriate crediting of withheld amounts or quarterly payments, when reporting to the Internal Revenue Service, a partnership must provide a U.S. taxpayer identification number or an EIN for each foreign partner and should therefore notify each foreign partner of the necessity of obtaining U.S. identifying numbers. *See* Rev. Rul. 84-158, 1984-2 C.B. 262 (partnership must request partner to furnish taxpayer identification number), *clarified*, Rev. Rul. 85-61, 1985-1 C.B. 355. A partnership must withhold or make quarterly payments with respect to a foreign partner even if the partnership does not have a taxpayer identification number for that partner.

SEC. 10. CREDITING OF WITHHELD AMOUNTS OR QUARTERLY PAYMENTS

.01 *In general.* Amounts withheld and paid over under section 1446 of the Code or paid quarterly under the ECI election relate to the partner's U.S. income tax liability for the taxable year of the partner in which the tax was withheld, or the taxable year to which an estimated tax payment on that date by a U.S. person would relate, and are thus creditable by the partner against its U.S. income tax liability for that taxable year. The early refund procedures of section 1.1445-6(g) of the regulations shall not apply under section 1446.

Amounts withheld and paid over during a taxable year of a partner or paid quarterly under the ECI election may not be applied against the partner's liability for a previous taxable year until the partner has filed a return establishing its U.S. tax liability for the taxable year in which the withholding took place, or to which the quarterly payment relates. The amount withheld and paid over under section 1446 of the Code or paid quarterly under the ECI election that is in excess of the partner's U.S. income tax liability as established on a tax return for that entire year may be credited against the partner's U.S. income tax liability for other years.

.02 *Procedural rule.* A partner that seeks a credit against its U.S. income tax liability for amounts withheld and paid over under section 1446 of the Code or paid quarterly under the ECI election must attach proof of payment to its U.S. income tax return for the taxable year in which it claims the credit. Proof of payment consists of a copy of all statements that the partnership is required to furnish under Section 9.04 of this revenue procedure, or copies of any official Internal Revenue Service form that may be prescribed.

SEC. 11. EXEMPT PARTNERSHIPS

Under section 1446(c)(2) of the Code a partnership is exempt from the requirements of section 1446 if 90 percent of the U.S. source income of the partnership and 90 percent of the effectively connected income of the partnership is properly allocated to U.S. persons, but only with respect to each foreign partner whose distributive share of effectively connected income for the partnership's taxable year, under a valid allocation pursuant to section 704(b), equals less than ten percent of the partner's entire distributive share of partnership income. Under section 1446(c)(2), a partnership must withhold on a foreign partner whose distributive share of effectively connected income is greater than or equal to ten percent of the partner's entire distributive share of partnership income for the taxable year of the partnership.

SEC. 12. PUBLICLY TRADED PARTNERSHIPS

Partnerships that are publicly traded on an established securities market within the meaning of section 1.1445-8T(a)(1) of the regulations may not make the ECI election described in Section 8 of this revenue procedure, and must withhold on section 1446 distributions under the rules of this revenue procedure. Such partnerships may designate nominees as withholding agents in accordance with the provisions of section 1.1445-8T, however, for purposes of withholding on distributions.

SEC. 13. TIERED PARTNERSHIPS

.01 *In general.* Any amount withheld under section 1446 of the Code or paid quarterly by a subsidiary partnership with respect to a foreign partnership (or a partnership that is a direct or indirect partner of such a foreign partnership) that is a partner in the subsidiary partnership shall be credited against the foreign partnership's liability to withhold under section 1446 or make quarterly payments under the ECI election. Such withholding or quarterly payments may occur because withholding is required under section 1446 with respect to a partner of any partnership that is itself a foreign partnership (since a foreign partnership is a foreign person). Such a foreign partnership (or another foreign or domestic partnership that is a direct to indirect partner in such a foreign partnership) may either receive a distribution which has already been subject to withholding by the subsidiary partnership in which it is a partner, or take into income a distributive share of effectively connected income on which a quarterly payment has been made under the ECI election. In addition, such a foreign partnership is itself subject to the requirements of section 1446, and potentially required to either withhold with respect to distributions it makes or elect to make quarterly payments with respect to the distributive share of effectively connected income of its foreign partners.

.02 *Reporting requirements.* A partnership that is a direct or indirect partner in a subsidiary partnership must comply with the reporting requirements of Section 9.04 of this revenue procedure (which applies in the absence of official Internal Revenue Service forms), with respect to its foreign partners. To the extent that a partnership is a direct or indirect partner in a subsidiary partnership and has had amounts withheld from distributions to it under section 1446 of the Code, or has had quarterly payments made on its behalf, it will receive a copy of the statements required under Section 9.04 of this revenue procedure to be sent to partners, and must in turn file the statements required under Sections 9.02 and 9.03 to the extent it is subject to section 1446, treating the amount withheld by the subsidiary partnership as a credit against its liability to withhold or make quarterly payments of tax. The foreign partnership must attach to the statement it must file under Sections 9.02 and 9.03 for itself, a copy of the statement it receives from the subsidiary partnership in which it is a partner, and must in turn provide its partners with a copy of any statements it receives from the subsidiary partnership along with the information described in Section 9.04. These statements will enable the partners of the foreign partnership to obtain appropriate credit for withheld amounts or paid quarterly by the foreign partnership and the lower tier partnership.

EFFECTIVE DATE

This revenue procedure is effective January 1, 1988.

---

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, Section 168).

Rev. Proc. 88-22

SECTION 1. PURPOSE

This revenue procedure modifies Rev. Proc. 87-56, 1987-2 C.B. 674, by providing: a) correct recovery periods for asset classes 48.12 and 49.4, b) new asset class designations or descriptions for horses in asset classes 01.221 through 01.225, and c) corrected text for asset classes 22.3, 30.1, 36.0, 37.11, and 49.223. This revenue procedure also clarifies Rev. Proc. 87-56 by making it clear that: a) nonresidential real property that is contained in any of the asset classes set out in section 5.02 of Rev. Proc. 87-56 has an applicable recovery period set out for the asset class, and b) the assets described in asset class 36.1 include any semi-conductor manufacturing equipment.

SEC. 2. BACKGROUND

Section 168(e)(2)(B) of the Internal Revenue Code defines nonresidential real property as section 1250 property that is not residential rental property or property with a class life of less than 27.5 years. For purposes of the general depreciation system, section 168(c) provides that the applicable recovery period for nonresidential real property is 31.5 years. For purposes of the alternative depreciation system, section 168(g)(2)(C) provides that the applicable recovery period for nonresidential real property is 40 years. *See* Rev. Proc. 87-57, 1987-2 C.B. 687.

SEC. 3. CLARIFICATION AND MODIFICATION OF REV. PROC. 87-56

.01 Section 5.02 of Rev. Proc. 87-56 sets out the applicable recovery periods for nonresidential real property, and section 5.01 states that those recovery periods are not contained in the tables that follow. Sections 5.01 and .02, however, fail to state that the recovery periods for nonresidential real property apply in all events because those recovery periods are separately prescribed by statute.

Section 5.02 of Rev. Proc. 87-56 is clarified by adding the following paragraph at the end thereof:

> Under section 168(e)(2)(B)(ii) of the Code, "non-residential real property" does not include any property described in an asset class with a class life of less than 27.5 years. Even if nonresidential real property is described in an asset class with a class life of 27.5 years or more, the applicable recovery period for that property is 31.5 years for purposes of the general depreciation system and 40 years

for purposes of the alternative depreciation system, regardless of the applicable recovery periods set out for the asset class in the tables below.

.02 Asset classes 01.22, 01.221, and 01.222 and their related text in section 5 of Rev. Proc. 87-56 are removed and replaced with the asset classes, class lives, recovery periods and associated footnotes set out in Table 1.

Rev. Proc. 88-+ +, Table 1

Asset class	Description of assets included	Class Life (in years)	Recovery Periods (in years) General Depreciation System	Alternative Depreciation System
01.221	Any breeding or work horse that is 12 years old or less at the time it is placed in service**	10	7	10
01.222	Any breeding or work horse that is more than 12 years old at the time it is placed in service**	10	3	10
01.223	Any race horse that is more than 2 years old at the time it is placed in service**	*	3	12
01.224	Any horse that is more than 12 years old at the time it is placed in service and that is neither a race horse nor a horse described in class 01.222**	*	3	12
01.225	Any horse not described in classes 01.221, 01.222, 01.223, or 01.224	*	7	12

+ + to be inserted, when available

* Property described in asset classes 01.223, 01.224, and 01.225 are assigned recovery periods under either section 168(e)(3)(A) or section 168(g)(2)(C) but have no class lives.

** A horse is more than 2 (or 12) years old after the day that is 24 (or 144) months after its actual birthdate.

.03 Asset class 36.1 is clarified to read in its entirety, "Any Semiconductor Manufacturing Equipment." The class life and recovery periods are unaffected.

.04 For purposes of the general depreciation system, the recovery period for asset class 48.12 is 10 years rather than 15 years.

.05 For purposes of the alternative depreciation system, the recovery period for asset class 49.4 is 28 years rather than 20 years.

.06 Asset class 22.3, "Manufacture of Carpets and Dyeing, Finishing, and Packaging of Textile Products and Manufacture of Medical and Dental Supplies," is corrected to read as follows:

Includes assets used in the production of carpets, rugs, mats, woven carpet backing, chenille, and other tufted products, and assets used in the joining together of backing with carpet yarn or fabric. Includes assets used in washing, scouring, bleaching, dyeing, printing, drying, and similar finishing processes applied to textile fabrics, yarns, threads, and other textile goods. Includes assets used in the production and packaging of textile products, other than apparel, by creasing, forming, trimming, cutting, and sewing, such as the preparation of carpet and fabric samples, or similar joining together processes (other than the production of scrim reinforced paper products and laminated paper products) such as the sewing and folding of hosiery and panty hose, and the creasing, folding, trimming, and cutting of fabrics to produce nonwoven products, such as disposable diapers and sanitary products. Also includes assets used in the production of medical and dental supplies other than drugs and medicines. Assets used in the manufacture of nonwoven carpet backing, and hard surface floor covering such as tile, rubber, and cork, are elsewhere classified.

.07 Asset class 30.1, "Manufacture of Rubber Products," is corrected to read as follows:

Includes assets used for the production of products from natural, synthetic, or reclaimed rubber, gutta percha, balata, or gutta siak, such as tires, tubes, rubber footwear, mechanical rubber goods, heels and soles, flooring, and rubber sundries; and in the recapping, retreading, and rebuilding of tires.

.08 Asset class 36.0, "Manufacture of Electronic Components, Products, and Systems," is corrected to read as follows:

Includes assets used in the manufacture of electronic communication, computation, instrumentation and control system, including airborne applications; also includes assets used in the manufacture of electronic products such as frequency and amplitude modulated transmitters and receivers, electronic switching stations, television cameras, video recorders, record players and tape recorders, computers and computer peripheral machines, and electronic instruments, watches, and clocks; also includes assets used in the manufacture of components, provided their primary use is in products and systems defined above such as electron tubes, capacitors, coils, resistors, printed circuit substrates, switches, harness cables, lasers, fiber optic devices, and magnetic media devices. Specifically excludes assets used to manufacture electronic products and components, photocopiers, typewriters, postage meters and other electromechanical and mechanical business machines and instruments that are elsewhere classified. Does not include semiconductor manufacturing equipment included in class 36.1

.09 Asset class 37.11, "Manufacture of Motor Vehicles," is corrected to read as follows:

Includes assets used in the manufacture and assembly of finished automobiles, trucks, trailers, motor homes, and buses. Does not include assets used in mining, printing and publishing, production of primary metals, electricity, or steam, or the manufacture of glass, industrial chemicals, batteries, or rubber products, which are classified elsewhere. Includes assets used in manufacturing activities elsewhere classified other than those excluded above, where such activities are incidental to and an integral part of the manufacture and assembly of finished motor vehicles such as the manufacture of parts and subassemblies of fabricated metal products, electrical equipment, textiles, plastics, leather, and foundry and forging operations. Does not include any assets not classified in manufacturing activity classes, e.g., does not include any assets classified in asset guideline classes 00.11 through 00.4. Activities will be considered incidental to the manufacture and assembly of finished motor vehicles only if 75 percent or more of the value of the products produced under one roof are used for the manufacture and assembly of finished motor vehicles. Parts that are produced as a normal replacement stock complement in connection with the manufacture and assembly of finished motor vehicles are considered used for the manufacture and assembly of finished motor vehicles. Does not include assets used in the manufacture of component parts if these assets are used by taxpayers not engaged in the assembly of finished motor vehicles.

.10 Asset class 49.223, "Substitute Natural Gas-Coal Gasification," is corrected to read as follows:

Includes assets used in the manufacture and production of pipeline quality gas from coal using the basic Lurgi process with advanced methanation. Includes all process plant equipment and structures used in this coal gasification process and all utility assets such as cooling systems, water supply and treatment facilities, and assets used in the production and distribution of electricity and steam for use by the taxpayer in a gasification plant and attendant coal mining site processes but not for assets used in the production and distribution of electricity and steam for sale to others. Also includes all other related land improvements. Does not include assets used in the direct mining and treatment of coal prior to the gasification process itself.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 87-56 is clarified and modified. When Rev. Proc. 87-56 is republished in the *Cumulative Bulletin*, it will reflect the changes made by this revenue procedure.

SEC. 5. EFFECTIVE DATE

This revenue procedure is effective as if Rev. Proc. 87-56 had originally contained the changes made by this revenue procedure.

---

26 CFR 601.602: Tax forms and instructions.

Rev. Proc. 88-23

SECTION 1. PURPOSE

The purpose of this revenue procedure is to supersede Rev. Proc. 85-41, 1985-2 C.B. 482, which provided the procedures to be followed to obtain a withholding certificate for purposes of sections 1.1445-3T and 1.1445-6T of the Temporary Income Tax Regulations concerning withholding on dispositions by foreign persons of United States (U.S.) real property interests. Final regulations under section 1445 of the Internal Revenue Code of 1986 were promulgated on December 24, 1986; this revenue procedure reflects those final regulations.

SEC. 2. BACKGROUND

The Tax Reform Act of 1984, section 129, 1984-3 (Vol. 1) C.B. 163, added section 1445 to the Internal Revenue Code as a means of enforcing the tax imposed pursuant to section 897 on dispositions by foreign persons of investments in U.S. real property. Section 1445(a) provides that a transferee of a U.S. real property interest from a foreign person must deduct and withhold a tax equal to 10 percent of the amount realized by the foreign person on the disposition. Section 1445(b) provides several exceptions to this requirement, including an exemption from withholding for persons who purchase property for use as a residence for $300,000 or less. Other exemptions under section 1445(b) include cases where the transferor furnishes an affidavit of nonforeign status, where the property transferred is stock that is regularly traded on an established securities market, and where a statement is obtained from the Internal Revenue Service that excuses withholding. Similarly, section 1445(c) provides that the amount required to be withheld can be reduced pursuant to a determination by the Service of the transferor's maximum tax liability upon the disposition. Sections 1.1445-3 and 1.1445-6 of the Income Tax Regulations provide rules concerning the issuance by the Service of a withholding certificate that reduces or eliminates withholding. This revenue procedure provides additional guidance concerning applications for withholding certificates.

SEC. 3. WITHHOLDING CERTIFICATES— IN GENERAL

.01 *Purpose of Withholding Certificate.* Withholding under section 1445 of the Code may be reduced or eliminated pursuant to a withholding certificate issued by the Service in accordance with the rules set forth in this revenue procedure. A withholding certificate may be issued by the Service in cases where reduced withholding is appropriate, where the transferor is exempt from U.S. tax, or where an agreement for the payment of tax is entered into with the Service. A withholding certificate that is obtained prior to a transfer notifies the transferee that no withholding is required or that reduced withholding is required. A withholding certificate that is obtained after a transfer has been made may authorize a normal refund or an early refund. *See* section 1.1445-3(g) of the regulations. A withholding certificate issued pursuant to the provisions of this revenue procedure serves to fulfill the requirements, as applicable, of section 1445(b)(4) concerning qualifying statements, section 1445(c)(1) concerning the transferor's maximum tax liability, or section 1445(c)(2) concerning the Secretary's authority to prescribe reduced withholding.

.02 *Limited Effect of a Withholding Certificate.* A withholding certificate serves only to adjust withholding obligations to correspond as closely as possible to the probable tax liability arising out of a transfer. Therefore, all determinations that are made by the Service in connection with the issuance of a withholding certificate apply solely for the limited purpose of determining withholding obligations under section 1445 of the Code and do not necessarily represent the Service's final view with respect to any substantive issue that may arise in connection with a transfer. Similarly, the Service's acceptance in connection with the issuance of a withholding certificate of any evidence provided or any representation made by a taxpayer is made only for that purpose, is not binding for any other purpose, and does not constitute a final determination of the truth or accuracy of any such evidence or representation.

.03 *Types of Withholding Certificates Available.* Pursuant to section 1.1445-3 of the regulations, a withholding certificate may be issued on the basis of any of the following:

1. A determination by the Service that reduced withholding is appropriate because either:

(a) The amount otherwise required to be withheld would exceed the transferor's maximum tax liability; or

(b) Withholding of a reduced amount would not jeopardize collection of the tax.

2. The exemption from U.S. tax of all gain realized by the transferor; or

3. An agreement of the payment of tax providing security for the tax liability, entered into by the transferee or transferor.

SEC. 4. APPLICATIONS FOR WITHHOLDING CERTIFICATES

.01 *General rules.* An application for a withholding certificate must be submitted to the Director, Philadelphia Service Center, P.O. Box 21086, Philadelphia, PA 19114. However, an application for a withholding certificate under section 6 (category 4 conforming security applications), section 9 (category 5 blanket withholding certificate applications), or section 10 (category 6 non-standard applications) of this revenue procedure must be submitted to the Assistant Commissioner (International), Director, Office of Taxpayer Service and Compliance, IN:C:E, 950 L'Enfant Plaza South, S.W.; COMSAT Building; Washington, D.C. 20024. Either a transferee or a transferor may apply for a withholding certificate, but only a transferor may apply for a blanket withholding certificate. The Service ordinarily will act upon an application not later than the 90th day after all information necessary for the Service to make a determination is received. However, in the case of an application for a certificate described in section 4.03(6) below, and in unusually complicated cases, the Service may be unable to provide a withholding certificate by the 90th day. In such a case, the Service will notify the applicant by the 45th day after all information necessary for the Service to make a determination is received that additional processing time will be necessary. The Service's notice may request additional information or explanation concerning particular aspects of the application and will provide a target date for final action (contingent upon the applicant's timely submission of any requested information). If an application for a withholding certificate is submitted before or on the date of a transfer and on the date of the transfer the application remains pending with the Service, the amount required to be withheld by the transferee is not required to be reported and paid over immediately. Instead, that amount (or such other amount as is appropriate) must be reported and paid over by the 20th day following the day upon which a copy of the withholding certificate or notice of denial is mailed by the Service.

.02 *Required signatures.* An application for a withholding certificate must be signed by a responsible officer in the case of a corporation, by a general partner in the case of a partnership, by a trustee, executor, or equivalent fiduciary in the case of a trust or estate, and, in the case of an individual, by the individual himself or herself. In addition, an application may be signed by an agent authorized to do so by a general or specific power of attorney. Form 2848 may be used for this purpose. The person signing the application must verify under penalties of perjury that all representations made in connection with the application are true, correct, and complete to the best of that person's knowledge and belief. To the extent that an application is premised in whole or in part on information provided by another party to the transaction, this information is to be supported by a written verification attached to that application signed under penalties of perjury by the party to whom it pertains. The application must follow the format set forth in section 4.04 below.

.03 *Categorizing of applications.* To facilitate the processing of applications for withholding certificates, this revenue procedure divides all applications into six basic categories as follows:

1. Applications for withholding certificates based on a claim that the transferor is entitled to nonrecognition treatment or is exempt from tax;

2. Applications for withholding certificates based solely on a calculation of the transferor's maximum tax liability;

3. Applications for withholding certificates under the special installment sales rules of section 7 of this revenue procedure;

4. Applications for withholding certificates based on an agreement for the payment of tax with conforming security;

5. Applications for blanket withholding certificates under section 9 of this revenue procedure; and

6. Applications for withholding certificates on any other basis.

.04 *Format for application.* All applications for withholding certificates must provide the following information in paragraphs labeled to correspond with the numbers and letters set forth below. Place "N/A" in the relevant space if the information requested is not applicable to the application being submitted.

1. (a) State which category of section 4.03, above, describes the application;

(b) In the case of category 4 applications (agreement for the payment of tax with conforming security):

(1) State whether the proposed agreement secures (A) the transferor's maximum tax liability, or (B) the amount that would otherwise be required to be withheld; and

(2) State whether the proposed agreement and security instrument conform to the standard formats set forth in this revenue procedure.

2. (a) Provide the name, identification number (if any), and home address (for an individual) or office address (for an entity) of the person applying for the withholding certificate. A mailing address may also be included.

(b) State whether the applicant is the transferee or transferor.

(c) Provide the name, address, and identification number (if none exists for any party the application must so state) of all other transferees and transferors (specifying whether such party is a transferee or transferor) of the U.S. real property interest with respect to which the withholding certificate is sought.

3. Provide the following information concerning the U.S. real property interest with respect to which the withholding certificate is sought:

(a) Type of interest (that is, interest in real property, in associated personal property, or in a domestic U.S. real property holding corporation);

(b) The contract price;

(c) Date of transfer;

(d) In the case of an interest in real property, its location and a general description of the property (for example, "10-story, 100 unit luxury apartment building"); and

(e) In the case of an interest in a U.S. real property holding corporation, the class or type and amount of the interest.

4. Provide full information concerning the basis for the issuance of the withholding certificate, in accordance with the rules of sections 4.05 through 4.10 below. Although the information to be included in this section of the application will necessarily vary from case to case, the rules set forth below provide general guidelines for the inclusion of appropriate information with respect to each category of application.

.05 *Information concerning category 1 applications (nonrecognition or exempt transfer).* If a withholding certificate is sought on the basis of a claim that the transaction is entitled to nonrecognition treatment or is exempt from U.S. taxation, provide the following:

1. A brief description of the transfer;

2. A brief summary of the law and facts supporting the claim of nonrecognition or exemption;

3. Evidence that the transferor has no unsatisfied withholding liability, as described in section 4.06(3); and

4. The most recent assessed value, for state or local property tax purposes, of the U.S. real property interest to be transferred, or other good faith estimate of its fair market value (no supporting evidence concerning the value of the property need be supplied).

.06 *Information concerning category 2 applications (determination of maximum tax liability).*

1. *In general.* If a withholding certificate is sought on the basis of a determination of the transferor's maximum tax liability, information must be provided to establish the two elements of that liability: (1) the maximum tax that may be imposed on the disposition, and (b) the transferor's unsatisfied withholding liability. Paragraphs 4.06(2) and .06(3), below, provide guidelines for the furnishing of such information for further information concerning the determination of the transferor's maximum tax liability. *See* section 1.1445-3(c) of the regulations.

2. *Maximum tax on disposition.* (a) The applicant must provide a calculation of the maximum tax that may be imposed on the disposition, including the following information:

(1) The amount to be realized by the transferor plus evidence confirming this amount, such as a copy of the signed contract relating to the transfer;

(2) Adjusted basis of the property plus evidence confirming the basis claimed, such as schedules of depreciation for tax purposes (if no depreciation schedules are provided, the application must state the nature of the use of the property and why depreciation was not allowed);

(3) Amounts to be recaptured with respect to accelerated depreciation, investment tax credit, or other items subject to recapture;

(4) Maximum capital gain and/or ordinary income tax rates applicable to the transfer;

(5) Tentative tax owed;

(6) Amount of any increase or reduction of tax to which the transferor is subject, including any reduction to which the transferor is entitled under a provision of a U.S. income tax treaty as well as evidence supporting the adjustment claimed. *See* section 1.1445-3(c)(2) of the regulations.

(b) For purposes of calculating the maximum tax that may be imposed upon a disposition, unused credit carryovers shall not be taken into account, and net operation loss carryovers (NOLs) (see section 172 of the Code) may be taken into account only if:

(1) The transferor claiming the NOL has been engaged in a trade or business in the U.S. during the three preceding tax years and has timely filed an income tax return for each of those years (copies of which should be attached);

(2) The claimed NOL has been reflected on previously-filed returns (no anticipated loss with respect to current year operations may be considered);

(3) The claimed NOL is not currently the subject of an examination by or a dispute with the Service;

(4) The transferor agrees that, if the amount of gain that the transferor claimed would be offset by the

NOL exceeds the amount of the gain actually recognized and offset by the claimed NOL when the transferor files its tax return for the current tax year, the transferor will pay interest upon the excess of the amount that should have been subject to withholding over the amount, if any, actually withheld, which interest will be computed:

(A) At the rates and in the manner prescribed by sections 6621 and 6622 of the Code; and

(B) With respect to the period between the date on which withholding would otherwise have been required and the date on which payment is made (for purposes of determining whether gain recognized on the disposition was in fact offset by the claimed NOL, the NOL is deemed first to offset income from sources other than the disposition of U.S. real property interests, and then to offset gain from such dispositions with respect to which a withholding certificate was issued in the order to which such dispositions occurred);

(5) The claimed NOL has not previously been used to reduce withholding upon other dispositions of U.S. real property interests or to reduce the amount of any other obligation or liability under U.S. internal revenue laws; and

(6) As part of the application, the transferor represents that:

(A) At least 80 percent of its gross income subject to U.S. taxation in the taxable year of disposition will be derived from U.S. real property interests; and

(B) In calculating the maximum tax that may be imposed on the disposition, the application calculates the NOL in the manner prescribed by the provisions of this section 4.06(2)(b), and the NOL is taken into account only to the extent permitted by such provisions.

3. *Transferor's unsatisfied withholding liability.* The applicant must provide a calculation of the transferor's unsatisfied withholding liability or evidence that it does not exist. That liability is the amount of any tax that the transferor was required to but did not withhold and pay over under section 1445 of the Code upon the acquisition of the subject U.S. real property interest or a prior interest. The transferor's unsatisfied withholding liability is included in the calculation of maximum tax liability so that such prior withholding liability may be satisfied by the transferee's withholding upon the current transfer. For further information, see section 1.1445-3(c)(3) of the regulations. Evidence that the transferor has no unsatisfied withholding liability includes any of the following items:

(a) Evidence that the transferor acquired the subject or prior real property interest before January 1, 1985;

(b) A copy of the Form 8288 that was filed by the transferor, and proof of payment of the amount shown due thereon, with respect to the transferor's acquisition of the subject or prior real property interest;

(c) A copy of a withholding certificate issued with respect to the transferor's acquisition of the subject or prior real property interest, plus a copy of Form 8288 and proof of payment with respect to any withholding required under that certificate;

(d) A copy of the nonforeign certificate furnished by the person from whom the subject or prior U.S. real property interest was acquired, executed at the time of that acquisition;

(e) Evidence that the transferor purchased the subject or prior real property interest for $300,000 or less and a statement, signed by the transferor under penalties of perjury, that the transferor purchased the property for use as a residence within the meaning of section 1.1445-2(d)(1);

(f) Evidence that the person from whom the transferor acquired the subject or prior U.S. real property interest fully paid any tax imposed on that transaction pursuant to section 897;

(g) A copy of a notice of nonrecognition treatment provided to the transferor pursuant to section 1.1445-2(d)(2) by the person from whom the transferor acquired the subject or prior U.S. real property interest; and

(h) A statement, signed by the transferor under penalties of perjury, setting forth the facts and circumstances that support the transferor's conclusion that no withholding was required under section 1445(a) with respect to the transferor's acquisition of the subject or prior real property interest.

.07 *Information concerning category 3 applications (installment sales).* See section 7 of this revenue procedure.

.08 *Information concerning category 4 applications (agreement for the payment of tax with conforming security).* If a withholding certificate is sought on the basis of an agreement for the payment of tax, the application must include:

1. Information establishing:

(a) The transferor's maximum tax liability, in accordance with section 4.06; or

(b) The amount otherwise required to be withheld pursuant to section 1445(a) of the Code;

2. A signed copy of the agreement proposed by the applicant; and

3. A copy of the security instrument proposed by the applicant. For further information concerning agreements for the payment of tax and security instruments, see sections 5 and 6 of this revenue procedure and section 1.1445-3 of the regulations.

.09 *Information concerning category 5 applications (blanket withholding certificate).* See section 9 of this revenue procedure.

.10 *Information concerning category 6 applications (non-standard applications).*

1. *Agreement for payment of tax with nonconforming security.* If the applicant seeks to enter into an agreement for the payment of tax, but wishes to provide a nonconforming type of security, the application must include:

(a) The information required by section 4.08 concerning category 4 applications;

(b) A description of the nonconforming security proposed by the applicant; and

(c) A memorandum of law and facts establishing that the proposed security is valid and enforceable and that it adequately protects the government's interest.

2. *Ohter non-standard applications.* An application for a withholding certificate not otherwise described in this revenue procedure must ex-

plain in detail the proposed basis for the issuance of the certificate and set forth the reasons justifying the issuance of a certificate on that basis.

.11 *Availability of records.* The applicant shall make available to the Director or to the Assistant Commissioner (International), within the time prescribed by the Director or Assistant Commissioner (International), respectively, all information that may be required by the Director or by the Assistant Commissioner (International) in order to verify that representations relied upon by the Director or the Assistant Commissioner (International) in accepting the agreement are accurate, and that the obligations assumed by the applicant will be performed pursuant to the agreement. Failure to provide requested information promptly will usually result in rejection of the application. Instead of or in addition to such rejection, the Director or the Assistant Commissioner (International), in his discretion, may also consider extension of an established target date for issuing a withholding certificate.

The parties shall agree that the review of books and records pursuant to the agreement shall not constitute an examination for purposes of section 7605(b) of the Code.

SEC. 5. AGREEMENT FOR THE PAYMENT OF TAX

.01 *In general.* The Service will issue a withholding certificate that excuses withholding or that permits a transferee to withhold a reduced amount if either the transferor or the transferee enters into an agreement for the payment of tax. An agreement for the payment of tax is a contract between the Service and any other person that consists of two necessary elements. Those elements are:

1. A detailed description of the rights and obligations of each; and

2. A security instrument or other form of security acceptable to the Assistant Commissioner (International).

.02 *Contents of agreement—In general.* An agreement for the payment of tax must either provide adequate security for the payment of the tax in accordance with section 6 of this revenue procedure or provide for the payment of the tax through a combination of security and withholding of tax by the transferee. The agreement must cover an amount described in subdivision (a) or (b) of this paragraph.

(a) *Tax that would otherwise be withheld.* An agreement for the payment of tax may cover the tax that would otherwise be required to be withheld pursuant to section 1445(a) of the Code. In addition to securing the amount computed pursuant to section 1445(a), the agreement must provide that the applicant will pay interest upon that amount, at the rates and in the manner prescribed by section 6621 and 6622, with respect to the period between the date on which the tax imposed by section 1445(a) would otherwise be due (*i.e.*, the 20th day after the date of transfer) and the date on which the transferor's payment of tax with respect to the disposition will be due. Interest and additions with respect to the tax also must be secured. In most instances, payments of interest and additions to tax may be secured by the same agreement that secures payment of taxes. At the discretion of the Assistant Commissioner (International) however, separate security agreements may be required.

(b) *Maximum tax liability.* An agreement for the payment of tax may provide for the payment of the transferor's maximum tax liability, determined in accordance with section 4.06(2) of this revenue procedure. The agreement must also provide for the payment of an additional amount equal to 25 percent of the amount determined under section 4.06(2). This additional amount secures the interest and additions to tax that would accrue between the date of a failure to file a return and pay tax with respect to the disposition, and the date on which the Service collects the tax pursuant to the agreement.

.03 All agreements for the payment of tax will be between the Assistant Commissioner (International) and the applicant furnishing the security or personally guaranteeing payment of any tax later determined to be due. In addition, the Assistant Commissioner (International) may require as a signatory any other party deemed to be appropriate. The Assistant Commissioner (International) may require such other terms and conditions, or vary the format as appropriate in the particular case, to provide adequate security.

.04 The agreement for the payment of tax should state the purpose and basis of the agreement. It should also recite any warranties or representations upon which the Assistant Commissioner (International) will be required to place material reliance in accepting the agreement.

.05 The agreement for the payment of tax must set forth in detail the obligations to be assumed and identify the nature of the security that is being offered. To the extent that the security is embodied in an instrument or document collateral to the agreement, such instrument or document must be incorporated by reference in the agreement.

.06 *Sample agreement.* The following example sets forth the language of an agreement for the payment of tax that in most circumstances will be acceptable to the Service:

1. This agreement is entered into pursuant to the provisions of section 1445 of the Internal Revenue Code (the "Code") and the regulations thereunder.

The signatories warrant that they are authorized under applicable law to enter into the agreement and undertake the actions and obligations specified herein.

2. ____________ (name) warrants that (s)he/it will make timely payment of any liability (including tax, penalties, interest, and additions to tax) that may become lawfully due and owing under the Code as a result of the disposition or distribution by _____ of the interest, or any part thereof, described in Exhibit(s) _____ [the "subject interest(s)"] giving rise to tax liability by reason of the operation of sections 871(b), 882, and/or 897 of the Code. The related security secures payment of such amounts. Security for the payment of such liability is provided in the amount of _____, in accordance with the requirements of section 1.1445-3(e)(2) of the Income Tax Regulations. The computation of the proper amount of security to be provided is set forth in Exhibit _____and such computation is hereby incorporated by reference.

3. The provisions of this agreement shall be construed as binding upon all signatories to this agreement, unless

the intent to exclude any one or more signatories is clearly set forth in the provisions or is clearly implicit in the terms hereof.

4. The amount of each deposit of estimated tax that will be required with respect to the amount recognized on the subject disposition may be collected by levy upon or recourse to the security as of the date following the date on which each such deposit is due (unless such deposit is timely made).

5. The entire amount of the liability may be collected by levy upon or recourse to the security at any time during the nine months following the date on which the payment of tax with respect to the subject disposition is due, subject to release of the security upon the full payment of the tax and any interest and penalties due. If the transferor requests an extension of time to file a return with respect to the disposition, the Assistant Commissioner (International) may require that the term of the security instrument be extended until the date that is nine months after the filing deadline as extended.

6. The applicant shall make available to the Assistant Commissioner (International) within 30 days of a request from the Assistant Commissioner (International) all information that may be required by the Assistant Commissioner (International) in order to verify that representations relied upon by the Assistant Commissioner (International) in accepting the agreement are accurate, and that the obligations assumed by the applicant are performed pursuant to this agreement.

7. The parties agree that the review of books and records pursuant to this agreement shall not constitute an examination for purposes of section 7605(b) of the Code.

8. Nothing in this agreement shall limit the Assistant Commissioner (International) from performing the obligations imposed upon or delegated to him under the law.

9. Upon the occurrence of any default by the applicant under the applicable provisions of this agreement, in addition to any and all other rights and remedies which the Assistant Commissioner (International) may have hereunder, or under any other applicable law, or otherwise, the Assistant Commissioner (International) may reduce the claim to judgment, otherwise enforce the security interests by any available judicial procedure, and exercise any other rights and remedies the Assistant Commissioner (International) may have at law, or in equity, or otherwise, including, but not limited to the right to apply toward payment of the obligations hereunder, without notice to the applicant, any sums which may then be held by the Assistant Commissioner (International) for said applicant.

10. For purposes of this agreement, the term "default" means a material misrepresentation of material fact or a failure to honor an obligation or warranty agreed to herein.

11. Except as otherwise provided in this agreement, no provision of this agreement shall be deemed to constitute a waiver of any right that any party may have to recover any amount in accordance with the laws, statutes, and regulations of the United States, nor shall any provision of the agreement be deemed to be an admission by any person, whether or not a party hereto, that such person is liable for any federal income tax, or, if a foreign corporation or nonresident alien, that such person is subject to the taxing jurisdiction of the United States, or if the Assistant Commissioner (International), that the facts upon which this agreement is based are true and accurate.

12. This agreement and all of its terms and conditions shall inure to the benefit of, and be binding upon, the Assistant Commissioner (International) and the applicant, and their respective successors and assigns.

13. All notices, instructions and other communications ("Notices") required or permitted to be given, forwarded, or transmitted hereunder or necessary or convenient in connection herewith shall be in writing and addressed to

Assistant Commissioner (International)
Director, Office of Taxpayer Service and Compliance
IN:C:E
950 L'Enfant Plaza South, S.W.
COMSAT Building
Washington, DC 20224
or

To [the applicant: the applicant's address etc], and shall be deemed to have been given only when delivered personally; or sent by first class U.S. mail (postage pre-paid, by registered or certified mail, return receipt requested); or sent by cable, telex, telegram or facsimile transmission (for example, telecopier) and confirmed by letter mailed the same day to the party receiving the notice. Any notice sent by mail to or from a place outside the continental United States shall be sent by air mail. Any notice sent by cable, telegram, or telex may be addressed to any published cable, telegram, or telex address that the addressee may have specified by notice to all the signatories. Any signatory may change the address or addresses to which communications are to be directed to it by giving written notice of such change to the persons above specified in the manner provided above, provided, however, that [the applicant] may establish or change an address to which notices are to be directed only if the new address is the address of [the applicant] itself or the address of a person with power of attorney to act for [the applicant] with respect to the disposition or distribution described in paragraph 2.

14. This agreement may not be amended, modified, superseded, or cancelled and none of the terms hereof may be waived, except by a written instrument executed by the Assistant Commissioner (International) and the other party or parties hereto sought to be charged thereby. In the case of a waiver of the breach of any term contained in this agreement in any one or more instances, the waiver shall be neither deemed to be nor construed as a further or continuing waiver of any such breach or term or any other term contained in this agreement.

15. This agreement may be executed in any number of counterparts with all the counterparts together constituting one and the same agreement.

16. The term "Assistant Commissioner (International)" as used herein also shall include any successors in office, the Deputy Assistant Commissioner (International) and any and all agents or employees thereof duty authorized for the purpose.

17. This agreement shall not be binding upon any signatory hereto until it has been signed by the Assistant Commissioner (International)

and the Assistant Commissioner (International) has received counterparts thereof duly executed by each of the signatories whose names appear at the end of this agreement.

18. No provision of this agreement shall relieve any party or person of any obligation or liability under the internal revenue laws of the United States, except as specifically provided in this agreement.

19. This agreement is made without prejudice to the assertion and/or collection of tax liabilities other than for any tax imposed by section 871(b)(1) or 882(a)(1) of the Code on any gain realized by the transferor on the disposition of the subject United States real property interest.

20. This agreement shall be governed, construed, and enforced in accordance with the laws of the United States of America and, where applicable, the laws of the State of [insert applicable local jurisdiction.]

21. It is agreed that nothing herein shall be construed to increase, decrease, or otherwise affect in any way the substantive tax liability of the taxpayer under any other provision of the Code.

22. The Assistant Commissioner (International) will not, in part or in full, release, subordinate, or return the security held with respect to this agreement except upon the payment of any liability determined to be due or upon the deposit of an acceptable amount of estimated tax or upon a showing to the satisfaction of the Assistant Commissioner (International) that the liability is zero.

I accept this Agreement	Underpenalties of perjury, I declare that I have examined this Agreement, related exhibits, schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete
Signature	Signature of Signatory/Power of Attorney
Title [Assistant Commissioner] (International)]	

SEC. 6. SECURITY

.01 There are four major types of security acceptable to the Service. These are:

1. *Bond with surety or guarantor.* The Service may accept as security with respect to a transferor's tax liability a bond that is executed with a satisfactory surety or guarantor. Only the following persons may act as surety or guarantor for this purpose:

(a) A surety company holding a certificate of authority for the Secretary as an acceptable surety on Federal bonds, as listed in Treasury Department Circular No. 570, published annually in the Federal Register on the first working day in July and as supplemented from time to time thereafter;

(b) A person who is engaged within or without the U.S. in the conduct of a banking, financing, or similar business under the principles of section 1.864-4(c)(5) of the regulations, and who is subject to U.S. or foreign (local or national) regulation of such business, if that person is otherwise acceptable to the Service; and

(c) A person who is engaged within or without the U.S. in the conduct of an insurance business that is subject to U.S. or foreign (local or national) regulation, if that person is otherwise acceptable to the Service.

2. *Bond with collateral.* The Service may accept as security with respect to a transferor's tax liability a bond that is secured by acceptable collateral. All collateral must be deposited with a responsible financial institution acting as escrow agent, or in the Service's discretion, with the Service. Only the following types of collateral are acceptable:

(a) Bonds, notes, or other public debt obligations of the U.S., in accordance with the rules of 31 CFR Part 225; and

(b) A certified, cashier's, or treasurer's check, drawn on an entity acceptable to the Service that is engaged within or without the U.S. in the conduct of a banking, financing, or similar business under the principles of section 1.864-4(c)(5) of the regulations and that is subject to U.S. or foreign (local or national) regulation of such business.

3. *Letter of credit.* The Service may accept as security with respect to a transferor's tax liability an irrevocable letter or credit issued by an entity acceptable to the Service that is engaged within or without the U.S. in the conduct of a banking, financing, or similar business under the principles of section 1.864-4(c)(5) of the regulations and that is subject to U.S. or foreign (local or national) regulation of such business. The Assistant Commissioner (International) will accept a letter of credit from an entity that is not engaged in a trade or business in the U.S. only if such letter may be drawn on an advising bank within the U.S.

4. *Guarantee.* The Service may accept as security with respect to a corporate transferor's tax liability a guarantee of the payment of such liability. The Service will accept such a guarantee only if (a) the corporation providing the guarantee is a corporation, foreign or domestic, any class of the stock of which is regularly traded on an established securities market on the date of the transfer; (b) the corporation providing the guarantee (1) is the transferor or holds, directly or indirectly, more than 80 percent of the voting stock of the transferor and (2) is engaged in a trade or business within the U.S.; and (c) has gross assets in the U.S. at least $25 million in excess of the value of the U.S. real property interest which is being disposed of.

5. *Other forms of security.* The Service, at its discretion, may in un-

usual circumstances accept any additional form of security that it finds to be adequate.

.02 Listed below are sample forms of security instruments that in most circumstances are acceptable to the Service, to be used when requesting a withholding certificate pursuant to section 1.1445-3 of the regulations.

1. BOND WITH SURETY/GUARANTOR

OBLIGATION. The undersigned, ______________________, the Guarantor(s), is (or if more than one, jointly and severally are) irrevocably held and firmly bound to pay the Internal Revenue Service the following portion of any tax (including any penalties, interest, and additions to tax) lawfully due and owing by any person listed below as a specified taxpayer as a result of the disposition or distribution of all or part of the subject interest in U.S. real property listed below as the subject interest(s):

* * *

CONDITIONS OF THIS OBLIGATION. The Internal Revenue Service may demand payment of the secured liability or any portion thereof at any time and for any reason. If the secured liability or requested portion is paid when requested by the Internal Revenue Service, this Guarantee shall be released to the extent so paid; otherwise, it shall remain in full force and effect until released in writing by the Internal Revenue Service.

SUBJECT INTEREST(S):
SPECIFIED TAXPAYER(S):
SIGNED, SEALED, AND DATED THIS ________ day of ________ 19__.

____
Guarantor [Seal]

____
Guarantor [Seal]

Corporate Guarantor

(Corporate Seal)
Attest:

By:____________________ [Corporate Seal]

____
Surety/Guarantor

____
Secretary

By:____________________ [Corporate Seal]
Title

2. BOND WITH COLLATERAL

OBLIGATION: The undersigned, ______________________, the Guarantor(s), is (or if more than one, jointly and severally are) irrevocably held and firmly bound to pay the Internal Revenue Service the following portion of any tax (including any penalties, interest, and additions to tax) lawfully due and owing by any person listed below as a specified taxpayer as a result of the disposition or distribution of all or part of the subject interest in U.S. real property listed below as the subject interest(s):

SECURITY: The above-bound Guarantor(s), in order to more fully secure the Internal Revenue Service in the payment of this obligation, hereby pledge(s) as security therefor the following collateral:

* * *

CONDITIONS OF THE OBLIGATION. The Internal Revenue Service may demand payment of the secured liability or any portion thereof at any time and for any reason. If the Guarantor(s) fail(s) to pay the amount requested by the Internal Revenue Service, the Assistant Commissioner (International) and his designates are authorized and empowered, in their sole discretion, in whole or in part, to exercise the power of attorney, contemporaneously executed and delivered, to collect, sell, transfer, or assign the above described security and apply the funds so received in full or partial satisfaction of any liability for taxes, interest, penalties, or additions to tax secured hereby. If the secured liability or portion requested is paid by the Guarantor(s) when requested by the Internal Revenue Service, this security shall be released to the extent so paid; otherwise, this obligation shall remain in full force and effect until released in writing by the Internal Revenue Service.

SUBJECT INTEREST(S):

SPECIFIED TAXPAYER(S):
SIGNED, SEALED, and DATED THIS ______ day of ______ 19____.

____
Guarantor [SEAL]

____
Guarantor [SEAL]

____
Corporate Guarantor

By: ______________________________
Title [Corporate Seal]

(Corporate Seal)
Attest:
____
Secretary

Individual's power of attorney

3. POWER OF ATTORNEY

I (we) . . . do hereby constitute and appoint the Assistant Commissioner (International) (and his/her designate) as attorney for me (us) and in my (our) name to collect, sell, assign, and transfer the following:

* * *

which has been deposited by me (us) as security for the faithful performance of my (our) bond, which is attached and incorporated by reference, and I (we) agree that, in case of any default in the performance of any of the conditions and stipulations of the bond, my (our) said attorney shall have full power to collect said security or any part thereof, or to sell, assign to another for the purposes of effecting either public or private sale, free from any equity of redemption and without appraisal or valuation notice and right to redeem being waived, and the proceeds of such sale for collection, in whole or in part, to be applied to the satisfaction of the liability secured by the bond in such manner as may be deemed in the best interest of the United States. I (We) further agree that the authority herein granted is irrevocable.

And for myself (ourselves), my (our several) administrators, executors, and assigns, I (we) hereby ratify and confirm whatever my (our) said attorney shall do by virtue of this power of attorney.

In witness whereof, I (we), herein above named, have executed this instrument and affixed my (our) seal this ______ day of ________, 19___.

______________ [SEAL]

State of ________________________))
ss
County of ________________________)

Before me, the undersigned, a notary public within and for the said county and State, personally appeared . . . [name(s) of Guarantor(s)], and acknowledged the execution of the foregoing power of attorney.

Witness my hand and notarial seal this ______ day of ________, 19___.

____
Notary Public

My Commission expires __________

Corporation's power of attorney

4. POWER OF ATTORNEY

____________________, a corporation duly incorporated under the laws of the State of and having its principal office in the city of ____________________, State of ____________________, in pursuance of a resolution of the Board of Directors, of said corporation passed on the day of ____________________, 19____, a duly certified copy of which resolution is attached hereto, does hereby constitute and appoint the Assistant Commissioner (International) (and his designates) as attorney for said corporation, for and in the name of said corporation, to collect or to sell, assign, and transfer the following:

* * *

which has been deposited by it as security for the faithful performance of the bond, a copy of which is attached, and which is incorporated by reference, and the undersigned agrees that, in case of any default in the performance of any of the conditions and stipulations of the bond, its said attorney shall have full power to collect said security or any part thereof, or to sell, assign, and transfer said security or any part thereof without notice, at public or private sale, or to transfer or assign to another for the purpose of effecting either public or private sale, free from any equity of redemption and without appraisal or valuation, notice and right to redeem being waived, and the proceeds of such sale for collection, in whole or in part, to be applied to the satisfaction of the liability secured by the bond, in such manner as may be deemed in the best interests of the United States. The undersigned further agrees that the authority granted is irrevocable.

And said corporation, hereby for itself, its successors and assigns, ratifies and confirms whatever its said attorney shall do by virtue of this power of attorney.

In witness whereof, the ______________________, the corporation above named, by ______________ (Named and title of officer), duly authorized to execute this instrument has caused the seal of the corporation to be affixed hereto this day of __________ 19__ .

Attest:

____

(Corporate seal) Secretary

By: ______________________________________

Title

State of __________
)
) ss
County of __________)

Before me, the undersigned, a notary public within and for the said county and State, personally appeared ________ (name and title of officer), and for and in behalf of said ________ corporation, acknowledged the execution of the foregoing power of attorney.

Witness my hand and notarial seal this _____ day of ____________ 19__.

[Notarial seal]

____

Notary Public

My Commission expires ____________________

LETTER OF CREDIT

Place:

Cable Address:
Date:

IRREVOCABLE STANDBY LETTER OF CREDIT	All drafts must be marked: Drawn under credit no.	Advising bank reference to
Advising bank	For account of	
To beneficiary Internal Revenue Service Assistant Commissioner (International) Director, Office of Compliance OP:I:C:E:666 950 L'Enfant Plaza South, S.W. COMSAT Building Washington, DC 20224		
		Expiration date

This refers to preliminary cable advice of this credit

Gentlemen:

We hereby establish our irrevocable letter of credit in your favor available by your drafts drawn at SIGHT and accompanied by documents specified below: NONE

We hereby engage with you that all drafts drawn under and in compliance with the terms of this credit will be duly honored if drawn and presented for payment at this office on or before the expiration date of this credit. The advising bank is requested to notify the beneficiary without adding their confirmation. Sincerely yours, Authorized counter signature Authorized signature	Advising bank's notification Place, date, name, and signature of the advising bank

6. GUARANTEE

OBLIGATION: The undersigned, ____________, the Guarantor(s), is (or if more than one, jointly and severally are) irrevocably held and firmly bound to pay the Internal Revenue Service the following portion of any tax (including any penalties, interest, and additions to tax) lawfully due and owing by any person listed below as a specified taxpayer as a result of any disposition or distribution taxable by reason of sections 871(b)(1), 882(a)(1), and/or 897 of the Code as to all or part of the subject interest in U.S. real property listed below as the subject interest:

CONDITIONS OF THIS OBLIGATION: The Internal Revenue Service may demand payment of the secured liability or any portion thereof at any time and for any reason. If the secured liability or requested portion is paid when requested by the Internal Revenue Service, this Guarantee shall be released to the extent so paid; otherwise, it shall remain in full force and effect until released in writing by the Internal Revenue Service.

SUBJECT INTEREST(S):

SPECIFIED TAXPAYER(S):

SIGNED, SEALED AND DATED THIS __________ day of __________

Guarantor [SEAL]

Corporate Guarantor

By: ______________________

[CORPORATE SEAL]

ATTEST:

Secretary

SEC. 7. INSTALLMENT SALES

.01 *In general.* A transferee as a result of a disposition of a U.S. real property interest occurring after December 31, 1984, is required to satisfy its withholding obligation based on the full amount of the sales price regardless of the amount of the payment by the transferee. If the transferor is a person other than a dealer and will report gain from the disposition under section 453 of the Code, a withholding certificate that permits the transferee to withhold at a reduced rate may be obtained under the rules of this section. Any withholding certificate must provide for payment of the interest on the deferred tax liability under section 453A(c) of the Code when applicable. No refund of the amount withheld will be made unless such a withholding certificate is obtained.

.02 With respect to installment sales subject to withholding under section 1445(a) of the Code, the Service will entertain requests for withholding certificates based on the transferee's agreement to do the following:

1. Withhold and pay over 10 percent, or such lesser amount as determined by the Director, of any down payment, including any liabilities of the transferor assumed by the transferee or liabilities to which the subject U.S. real property interest was subject immediately before and after the transfer;

2. Withhold 10 percent, or such lesser amount as may be determined by the Director, of each subsequent payment and the interest on the deferred tax liability under section 453A(c) of the Code (these amounts are in addition to any other amount required to be withheld under section 1441 or 1442);

3. Pay over all amounts withheld using Forms 8288 and 8288-A, including thereon the identification number of the transferor; and

4. Notify the Director prior to the disposition or encumbrance of the subject U.S. real property interest, and upon such disposition or encumbrance pay over to the Service the amount remaining to be withheld pursuant to section 1445(a).

5. If the transferor pledges the installment obligation in exchange for all or a portion of the proceeds due on the installment obligation and includes in gross income under section 453A(d) of the Code the net proceeds of the secured indebtedness, the transferee's obligation to withhold under a reduced withholding certificate nevertheless continues until an amended withholding certificate is issued even though the transferor includes the proceeds in gross income.

SEC. 8. APPLICATION FOR WITHHOLDING CERTIFICATES FOR AMOUNTS REQUIRED TO BE WITHHELD UNDER SECTION 1445(e)

.01 *In general.* Pursuant to the provisions of sections 1.1445-5(c), (d), and (e) of the regulations, withholding under section 1445(e) of the Code may be reduced or eliminated pursuant to a withholding certificate issued by the Service in accordance with the rules of section 1.1445-6. A withholding certificate may be issued in cases where adjusted withholding is appropriate, where the relevant taxpayers are exempt from U.S. tax, or where an agreement for the payment of tax is entered into with the Service. The term "relevant taxpayer" shall mean any foreign person that will bear substantive income tax liability by reason of a transaction upon which withholding is required under section 1445(e).

.02 *Applications.* An application for a withholding certificate pursuant to section 1.1445-6 of the regulations must follow the format set forth in section 4.04 of this revenue procedure and provide the information described in sections 4.05 through 4.10, with the following adjustments:

1. The application must include a preliminary item stating that it relates to withholding under section 1445(e) of the Code and specifying the applicable provisions of that section;

2. Item 2(b) of section 4.04 must state whether the applicant is a relevant taxpayer or a person required to withhold (and in what capacity that person is required to withhold; for example, as trustee);

3. Item 2(c) of section 4.04 must provide the required information with respect to each relevant taxpayer with respect to which adjusted withholding is sought; and

4. Information concerning the basis for the issuance of the certificate must be provided with respect to each relevant taxpayer.

.03 *Installment sales.* With respect to installment sales subject to withholding under section 1445(e) of the Code, the Service will entertain requests for withholding certificates based on the entity's or the fiduciary's agreement to do the following:

1. Withhold and pay over a portion, in an amount determined appropriate under section 1445(e) by the Director, of any down payment received, including any liabilities of the entity assumed by the transferee or liabilities to which the subject U.S. real property interest was subject immediately before and after the transfer;

2. Withhold a portion, in an amount determined appropriate under section 1445(e) by the Director, of each subsequent payment received (this amount is in addition to any other amount required to be withheld under sections 1441 or 1442);

3. Pay over all amounts withheld using Forms 8288 and 8288-A, including thereon the identification number of the interest holder subject to withholding; and

4. Notify the Director, prior to the disposition or encumbrance of the subject installment obligation, and upon such disposition or encumbrance pay over to the Service the amount remaining to be withheld under section 1445(e).

SEC. 9. BLANKET WITHHOLDING CERTIFICATE

.01 *In general.* The Assistant Commissioner (International) may issue a withholding certificate (blanket withholding certificate) that excuses withholding with respect to multiple dispositions of U.S. real property interests by the transferor or the transferor's legal representative during a period of no more than 12 months. A blanket withholding certificate may be issued if the transferor holding the U.S. real property interests provides a letter of credit as specified in paragraph 1 of this subsection .01 or a guarantee as specified in paragraph 2 of this subsection .01 and enters into an agreement with the Service that meets the requirements of paragraphs 3 and 4 of this subsection .01.

1. For dispositions not subject to section 1445(e) of the Code, the transferor must provide an irrevocable letter of credit in an amount equal to the greater of (i) $100,000 or (ii) 10 percent of the amount to be realized on the projected dispositions covered by the certificate. For dispositions subject to section 1445(e), the transferor must provide an irrevocable letter of credit in an amount equal to the greater of (i) $100,000 or (ii) the tax that section 1445(e) would require to be withheld. The letter of credit must meet the requirements of paragraph 3 of subsection 6.01 of this revenue procedure and otherwise must be acceptable to the Assistant Commissioner (International). In addition, the letter of credit by its terms must be valid until at least the last day of the ninth month following the date (including extensions of time) on which a return will be required to be filed with respect to the tax year in which the 12th month covered by the withholding certificate falls. A letter of credit in the form specified in subsection 6.02(5) in most circumstances will be acceptable to the Service when requesting a blanket withholding certificate.

2. Alternatively, the Service may accept as security for a blanket withholding certificate with respect to a corporate transferor's tax liability a guarantee of the payment of such liability. The Service will accept such a guarantee only if (a) the corporation providing the guarantee is a corporation, foreign or domestic, any class of the stock of which is regularly traded on an established securities market on the date of the transfer; (b) the corporation providing the guarantee (1) is the transferor or holds, directly or indirectly, more than 80 percent of the voting stock of the transferor and (2) is engaged in a

trade or business within the U.S.; and (c) has gross assets in the U.S. at least $25 million in excess of the U.S. real property interest being disposed of.

Additionally, the transferor corporation must have filed United States corporate income tax returns for the prior consecutive three years and the guarantee otherwise must be acceptable to the Assistant Commissioner (International). The guarantee by its terms must be valid until at least the last day of the ninth month following the date (including extensions of time) on which a return will be required to be filed with respect to the tax year in which the 12th month covered by the withholding certificate falls. A guarantee in the form specified in subsection 6.02(6) will be acceptable to the Service in most circumstances when requesting a blanket withholding certificate.

3. The transferor must provide with the letter of credit described in paragraph 1 of this subsection or the guarantee described in paragraph 2 of this subsection an executed tax payment and security agreement securing the payment of tax with respect to the projected dispositions covered by the blanket withholding certificate. The agreement must meet the requirements of subsections 5.02 through 5.05 of this revenue procedure as modified to take account of this subsection 9.01 and otherwise must be acceptable to the Assistant Commissioner (International). In addition, the agreement must contain the terms as to notification of specific dispositions required by paragraph 4 of this subsection 9.01 and must provide that, in the event of a failure by the transferor to provide such notification or to file a return in a timely manner, deposit estimated tax in a timely manner, or to pay tax in a timely manner, with respect to the gain on one or more of the dispositions covered by the certificate, the Assistant Commissioner (International) may drawn upon the letter of credit or demand payment under the guarantee to satisfy the transferor's liability for any tax imposed by section 871(b)(1) or 882(a)(1) of the Code, plus interest and penalties, if any, on any one or more dispositions covered by the certificate.

4. The agreement required by paragraph 3 of this subsection must state that the transferor agrees to notify the Assistant Commissioner (International) before or on the date of any disposition of a U.S. real property interest covered by the blanket withholding certificate. The notice shall include the following information:

(a) The name, legal address, and taxpayer identification number, if any, of the transferor or the name and legal address of a legal representative of the transferor with the power to bind the transferor with respect to the disposition;

(b) The name, legal address, and taxpayer identification number, if any, of the transferee or the name and legal address of a legal representative of the transferee with the power to bind the transferee with respect to the disposition:

(c) A description of the U.S. real property interest to be transferred and the anticipated date of the transfer;

(d) The amount that would otherwise have been required to be withheld on the transfer (10 percent of the amount realized unreduced by the maximum tax calculation or for any other reason);

(e) The cumulative total of amounts that would otherwise have been required to be withheld with respect to dispositions (i) which have already taken place or are scheduled to take place prior to the disposition with respect to which notice is being given and (ii) with respect to which the Assistant Commissioner (International) has not sent the notice described in subsection .02(1) below;

(f) The amount of the original letter of credit provided or the amount the guarantor is bound to pay the Service under the guarantee; and

(g) A copy of the transferor's withholding certificate.

An agreement in the form prescribed by subsection 5.06 of this revenue procedure in most cases will be acceptable to the Service for purposes of paragraphs 3 and 4 of this subsection 9.01, with the following modifications: (i) The form should reflect and describe, as the "subject interests," the projected dispositions to be covered by the blanket withholding certificate to which the agreement will relate, (ii) paragraph 2 of the form should be modified to state that the agreement is entered into in connection with an application for a blanket withholding certificate and will extend to all dispositions covered by the blanket withholding certificate, (iii) the third sentence of paragraph 2 should be revised to read "Security for the payment of such liability is provided by an irrevocable letter of credit in the amount of , in accordance with the requirements of subsection 9.01(1) of Rev. Proc. 87-23 or by a guarantee in accordance with the requirements of subsection 9.01(2) of Rev. Proc. 87-23", (iv) a new paragraph should be added to the form (designated as paragraph 3, with the other paragraphs being renumbered accordingly), containing the terms of paragraph 4 of this subsection 9.01, and (v) paragraph 5 of the form (paragraph 6 as renumbered) should be revised to read:

"6. In the event of any failure by the transferor or the transferor's legal representative (i) to notify the Assistant Commissioner (International) properly, in accordance with paragraph 4, of a disposition of a U.S. real property interest covered by this agreement and the blanket withholding certificate to which it relates, or (ii) to file a return in a timely manner, to deposit estimated tax in a timely manner, or to pay tax in a timely manner, with respect to the gain on one or more dispositions covered by this agreement and such certificate, the Assistant Commissioner (International) may draw upon the letter of credit provided or the guarantee as related security under this agreement in full to the extent of the tax imposed by section 871(b)(1) or section 882(a)(1) of the Code on any one or more dispositions covered by this agreement and such certificate, plus interest and additions to tax, if any. This amount shall be in addition to any other civil or criminal penalties that may apply with respect to the applicant's use of the withholding certificate in violation of the terms thereof."

.02 A withholding certificate issued by the Assistant Commissioner (International) under this section will state that no withholding is required with respect to any disposition of a U.S. real property interest by the applicant provided that (1) before the date of the transfer, the Assistant Commissioner (International) does not provide notice to the person who would otherwise be required to withhold (discussed in paragraph 1 below) that such withholding is required and (2) the person who would otherwise be required to withhold timely provides the information and material described in paragraph 2 below and the disposition as consummated does not materially fail to correspond to the information so provided.

1. If one of the following conditions occurs, the Assistant Commissioner (International) will provide notice to the applicant, and to the person required to withhold, that withholding is required despite the prior issuance of a withholding certificate:

(a) The applicant's letter of credit or amount under the guarantee, in light of prior dispositions, is not sufficient to cover the amount otherwise required to be withheld on the transfer, or

(b) The applicant has otherwise violated the provisions of this section.

2. To be exempt from withholding tax liability, the person that would otherwise be required to withhold must, before or on the day of the closing of a transaction, provide a statement to the Assistant Commissioner (International) containing the following information and material:

(a) The name, legal address, and taxpayer identification number, if any, of the transferee or the name and legal address of a legal representative of the transferee with the power to bind the transferee with respect to the acquisition;

(b) The name, legal address, and taxpayer identification number, if any, of the transferor or the name and legal address of a legal representative of the transferor with the power to bind the transferor with respect to the acquisition;

(c) A description of the acquired U.S. real property interest and the anticipated date of the acquisition;

(d) The total contract price of the acquired U.S. real property interest; the amount of liabilities, if any, to be assumed by the transferee; and the amount of liabilities, if any, to which the property is to be acquired is subject; and

(e) A copy of the transferor's withholding certificate.

.03 The Assistant Commissioner (International) will, upon request, provide the transferor with a copy of a security agreement submitted pursuant to paragraph 9.01(2) executed by the Assistant Commissioner (International), but such an executed copy is not needed to establish the validity of the blanket withholding certificate for purposes of the subject disposition. Provided that notice is not given by the Assistant Commissioner (International) under section 9.02(1) and provided that the transferee timely provides the required information and materials, the withholding certificate remains valid.

.04 In the event of any failure by the transferor or the transferor's legal representative to notify the Assistant Commissioner (International) properly, in accordance with section 9.01(3), of a disposition of a U.S. real property interest, or to file a return in a timely manner, to deposit estimated tax in a timely manner, or to pay tax in a timely manner, with respect to the gain on one or more dispositions covered by the blanket withholding certificate, the letter of credit provided under section 9.01(1) or the guarantee provided under section 9.01(2) may be drawn upon in full to the extent of the tax imposed by section 871(b)(1) or section 882 (a)(1) of the Code, plus interest and additions to tax, if any, on any one or more dispositions covered by the blanket withholding certificate. This amount shall be in addition to any other civil or criminal penalties that may apply with respect to the applicant's use of the withholding certificate in violation of the terms thereof.

SEC. 10. AUTHORIZED REPRESENTATIVE

In any situation covered by this revenue procedure in which a person acts for or is designated as a legal representative of either a transferor or a transferee, such person must be authorized by either a general or a specific power of attorney on file with the Director or the Assistant Commissioner (International). Form 2848 may be used for this purpose.

SEC. 11. INQUIRIES

Address all inquiries about this revenue procedure to:
Director
Philadelphia Service Center
P.O. Box 21086
Philadelphia, Pa. 19114

Or, with respect to category 4, 5, and 6 applications:

Assistant Commissioner (International)
Director, Office of Taxpayer Service and Compliance
IN:C:E
950 L'Enfant Plaza South, S.W.
COMSAT BUILDING
Washington, D.C. 20224

SEC. 12. EFFECTIVE DATE

This revenue procedure is effective for all applications for withholding certificates submitted after May 9, 1988.

SEC. 13. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 85-41 is superseded.

---

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, Sections 117, 1441, 1461; 1.117-1, 1.1441-2, 1.1461-2.)

Rev. Proc. 88-24

SECTION 1. PURPOSE

This revenue procedure provides that payors of U.S. source grant or scholarship income to foreign students and grantees who are holders of F, J, or M visas may withhold in certain circumstances at less than the statutory rate under section 1441 of the Internal Revenue Code of 1986.

Recipients of U.S. source grants or scholarships who (i) are not eligible for the exclusion from U.S. gross income under section 117(a) of the Code, (ii) are eligible for the exclusion from U.S. gross income only as to a portion of their grant or scholarship, or (iii) receive grants or scholarships which are wholly or partly exempt under an applicable tax treaty, may be subject to the provisions of this revenue procedure.

Withholding procedures for foreign students and trainees for whom an applicable tax treaty provides an exclusion from U.S. income for compensation for services performed are contained in Rev. Proc. 87-8, 1987-1 C.B. 366.

SEC. 2. BACKGROUND

The Tax Reform Act of 1986 amended the definition of a scholarship excludable from gross income under section 117(a) of the Code to limit the amount excludable from gross income to certain tuition, fees, books, supplies, and equipment required for courses of instruction incurred by an individual who is a candidate for a degree. Under former law, the excludable amount allowed for degree candidates included any amount received as a scholarship (not including compensation). For nondegree candidates, the excludable amount allowed was $300 per month if certain conditions were met. Thus, many scholarships were excludable from gross income in whole or in part. Exempt scholarship amounts of foreign students were not subject to withholding under section 1441.

Because of the amendments to section 117(a) of the Code made by the Tax Reform Act of 1986, fewer scholarships are excludable from gross income, either in whole or in part. Scholarships awarded to foreign students that are not excludable from gross income are subject to withholding under section 1441. In general, the statutory withholding rate under section 1441 is 30 percent. In the case of nonexempt amounts that are incident to a scholarship exempt under section 117(a), however, the withholding rate is lowered to 14 percent. Because both of these rates may exceed the actual tax liability of the foreign scholarship or grant recipient, the Internal Revenue Service is providing a reduced withholding procedure to approximate the actual tax liability of foreign scholarship or grant recipients.

SEC. 3. GENERAL PROCEDURE

Foreign students and grantees who wish to avail themselves of reduced withholding under section 1441 of the Code with respect to U.S. source taxable grant or scholarship income must complete a Form W-4 annually, subject to the special instructions contained in Section 4 of this revenue procedure. Properly completing the Form W-4 includes providing a U.S. taxpayer identifying number if one has been assigned. The Internal Revenue Service will assign a temporary number to a nonresident alien when the alien files the Form 1040NR.

The properly completed Form W-4 should be forwarded to the administrator agency (*i.e.*, the payor) of the grant or scholarship. The administrator agency may rely on the Form W-4 (but is not required to do so) and withhold from a U.S. source grant or scholarship (or the nonexempt portion of a U.S. source grant or scholarship) paid to the foreign student or grantee on the basis of the properly completed Form W-4. The administrator agency will be subject to all relevant Code provisions and regulations, including section 1461 of the Code, which imposes liability for the tax to be withheld upon the withholding agent, and section 1.1461-2 of the Income Tax Regulations, which requires the filing of Forms 1042 and 1042S with respect to each student or grantee who has submitted a Form W-4 to the administrator agency.

Each individual student or grantee is required to file an annual income tax return under section 6012 of the Code. Section 874(a) makes the filing of a return a prerequisite to the allowance of deductions, including the allowance for personal deductions. If a student or grantee is in the United States during more than one taxable year, the student or grantee must attach to the annual Form W-4 a statement indicating that a proper U.S. income tax return was filed for the previous taxable year. If the student or grantee has not been in the United States for at least a portion of a taxable year, the student or grantee must attach to the annual Form W-4 a statement that he intends to file a timely return with respect to such year if the return is not yet due. A nonresident alien who is married to a citizen or resident of the United States and who elects to file a joint return under section 6013 is not eligible for relief under this revenue procedure.

SEC. 4. SPECIAL INSTRUCTIONS FOR COMPLETING FORM W-4

.01 *Standard deductions.* Under section 63(c)(6)(B) of the Code, a nonresident alien individual is not eligible for the standard deduction as defined in section 63(c)(2). Therefore, the standard deduction may not be taken into account by a nonresident alien student or grantee for purposes of reduced withholding under section 1441. Line B on the Personal Allowances Worksheet of Form W-4 should be completed by entering zero.

.02 *Personal exemptions.* Section 873(b) of the Code limits the number of personal exemptions allowed by section 151 to one exemption unless the taxpayer is a resident of a contiguous country (*i.e.*, Canada or Mexico) or is a national of the United States. A national of the United States for purposes of the Code is a person who owes allegiance to the United States such as, for example, a native of American Samoa. A resident of Japan may claim personal exemptions for a spouse and children who live with the taxpayer in the United States at some time during the taxable year; the amount of the additional exemption, however, is the product of the full exemption otherwise allowable and a fraction, the numerator of which is the taxpayer's gross income that is effectively connected with a U.S. trade or business for the taxable year, and the denominator of which is the taxpayer's income from all sources for that taxable year. See IRS Publication 519 for further details and section 871(c) regarding treatment of certain grant or scholarship income as effectively connected income.

Section 1.1441-3(e)(2) of the Income Tax Regulations requires that the allowable personal exemptions be prorated upon a daily basis for the period during which the nonresident alien student or trainee is present in the United States. For taxable years beginning after 1987, the daily amount is determined by dividing the exemption amount for a particular taxable year by 365 (366 in the case of a leap year). Thus, a married nonresident alien, not a resident of either Mexico or Canada or a national of the United States, is allowed only one personal exemption equal to the daily proration amount times the number of days for which the nonresident alien is present in the United States during the taxable year. For purposes of completing Form W-4 under this revenue procedure, the student or grantee must use the number of days he or she expects to be present in the United States during the taxable year. Enter the personal exemption amount as calculated above on line A of the Personal Allowances Worksheet. Enter zero on lines C and D of the Personal Allowances Worksheet unless the student or grantee is a resident of either Mexico, Canada, or is a national of the United States. In that case, if the student or grantee is married or has dependents, a personal exemption amount for the spouse and each dependent may be calculated in the same manner using the same number of days as for the student or trainee and entered as appropriate on lines C and D. Residents of Japan who are eligible for exemptions for a spouse and children should calculate the appropriate exemption amount and enter that amount on lines C and D.

Nonresident aliens are not eligible for head of household status under section 2(b)(3) of the Code or for the credit for the elderly and disabled under section 22(f). Because the child-care credit is available only to taxpayers filing a joint return, it is not available to aliens subject to this revenue procedure. Therefore, make no entries on lines E or F of the Personal Allowances Worksheet.

.03 *Section 162 deductions.* Section 162 deductions may be taken only if the guidelines provided in Rev. Rul. 83-82, 1983-1 C.B. 45, are met. A nonresident alien who realistically expects his training or study period to last less than two years may be eligible for deductions under section 162 of the Code if he meets all three claimed abode tests set forth in Rev. Rul. 83-82. An expected or actual stay of two years (*i.e.*, 24 months) or longer is considered an indefinite stay and not a stay away from home, regardless of any other facts or circumstances. No section 162 deductions are allowed with respect to stays of two years or longer. If a student or grantee claims section 162 deductions for purposes of withholding, the student or grantee must attach a statement to the annual Form W-4, signed under penalties of perjury, indicating that the student or grantee meets the three claimed abode tests.

If the anticipated actual expenses allowable under sections 1.162-5(c)(1) and 1.162-5(e) of the regulations are known, the anticipated actual amounts may be allowed as a deduction for purposes of completing the Form W-4. In the event that the exact amount of such expenses is not known at the time of the completion of the Form W-4, the current U.S. government per diem allowances in effect for participants in the Career Education Program under the Federal Travel Regulations may be used to determine the deduction allowable under section 162 of the Code for purposes of completing the Form W-4. *See* IRM 1763-67(a), Travel Handbook. MT 1763-71 (Nov. 12, 1987). The current amount allowable as of the date of issuance of this revenue procedure is $18.00 per day.

The actual expenses or the per diem allowance should be entered on Line A of the Personal Allowances Worksheet in addition to the personal exemption amount as calculated under section 4.02 of this revenue procedure.

.04 *Tax exempt portions of a scholarship or grant under section 117(a) or pursuant to a tax treaty.* Amounts that are exempt from taxation under section 117(a) of the Code or pursuant to a tax treaty should be entered on Line A of the Personal Allowances Worksheet.

.05 *Other allowable deductions.* Other deductions allowable to a nonresident alien under the Code should be added to the amount on Line A of the Personal Allowances Worksheet.

.06 *Final completion of form.* Provide the total of the amounts entered on lines A through F on line G. Submit the Personal Allowances Worksheet to the administrator agency with Form W-4 and any required statements.

SEC. 5. REVIEW BY ADMINISTRATOR AGENCY

Upon receiving a Form W-4 and a Personal Allowances Worksheet from a foreign student or grantee, the administrator agency shall review the Form W-4 and the Personal Allowances Worksheet to ensure that all necessary and required information is provided, including (i) the student or grantee's temporary taxpayer identification number assigned by the Internal Revenue Service (if one has been assigned), (ii) if section 162 deductions are claimed, the statement of the student or grantee indicating that the three claimed abode tests are met, and (iii) the statement certifying that the student or grantee filed a proper federal income tax return for the previous taxable year or that the student or grantee intends to file a timely return with respect to such taxable year.

Except as provided in the next paragraph, if the administrator agency acting as withholding agent knows or has reason to know that any of the facts or representations on the Form W-4 or the Personal Allowances Worksheet may be false (including claims for deductions or exemptions for which the student or grantee is not entitled) or if a required statement is not submitted, the withholding agent may not accept the W-4 and must withhold at the rate required under section 1441 of the Code. Except as provided in the next paragraph, if the withholding agent accepts the Form W-4 and the Personal Allowances Worksheet and subsequently knows or has reason to know that any of the facts and representations contained therein may be false (including claims for deductions or exemptions for which the student or grantee is not entitled), the withholding agent must withhold at the rate required under section 1441.

If, however, the withholding agent knows or has reason to know that a student or grantee has extended a stay in the United States beyond 24 months and erroneously continues to claim section 162 deductions, the withholding agent may accept an otherwise correct Form W-4 and Personal Allowance Worksheet and continue to withhold under the authority of this revenue procedure, but without regard to the claimed section 162 deductions.

SEC. 6. WITHHOLDING BY ADMINISTRATOR AGENCY

The administrator agency must withhold as provided under section 3402 of the Code as if the grant or scholarship income were wages thereunder. In calculating the amount to be withheld thereunder, the administrator agency may reduce the gross amount of the scholarship or grant by the total amount on line G of the Personal Allowances Worksheet. The administrator agency shall be liable as withholding agent for the payment of the tax required to be deducted and withheld under this revenue procedure to the extent provided in section 1.1461-3 of the regulations.

SEC. 7. REPORTING REQUIREMENTS OF ADMINISTRATOR AGENCY

The administrator agency shall comply with the provisions of section

1.1461 of the regulations relating to the filing of Forms 1042 and 1042S each March 15 with respect to each foreign student or grantee. A Form 1042S must be filed with respect to each foreign student or trainee receiving a grant or scholarship. A Form 1042S is not required to be filed with respect to compensation income that is reported on a Form W-2. Amounts shown on the Form 1042S must be stated in U.S. currency. All items of income subject to withholding under section 1441 of the Code paid during the previous calendar year to nonresident alien individuals and withheld on under the authority of this revenue procedure must be reported on the Form 1042S.

A Form 1042 is required to be filed each calendar year even though no tax was required to be withheld under the Code during the calendar year if the withholding agent is required to make an information return on Form 1042S with respect to any payments made during the year. Form 1042 shall be filed with the Internal Revenue Service Center, Philadelphia, PA 19255.

SEC. 8. EFFECTIVE DATE

This revenue procedure shall be effective beginning January 1, 1988. A failure to withhold under section 1441 of the Code prior to this date may be justified by the administrator agency demonstrating that, had a proper Form W-4 been filed under the procedures contained in this revenue procedure, the amount actually withheld would have been appropriate or that no withholding would have been required.

---

26 CFR 601.201: Rulings and determination letters.
(Also Part I, Section 368; 1.368-1.)

Rev. Proc. 88-25

SECTION 1. PURPOSE

Rev. Proc. 88-3, page 579, this Bulletin, contains in section 3 a list of those areas of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Technical and International) in which advance rulings or determination letters will not be issued. The present revenue procedure modifies Rev. Proc. 88-3 by amending section 3.01(24), relating to corporate recapitalizations, and makes a conforming modification to Rev. Proc. 88-1, page 557, this Bulletin.

SEC. 2. BACKGROUND

Section 3.01(24) of Rev. Proc. 88-3 states that the Internal Revenue Service will not issue a ruling or determination letter as to whether a transaction constitutes a corporate recapitalization within the meaning of section 368(a)(1)(E) of the Code (or a transaction that also qualifies under section 1036) except when the recapitalization is an integral part of a larger transaction and it is impossible to determine the tax consequences of the larger transaction without making a determination with regard to the recapitalization.

In addition, Rev. Proc. 88-1, in section 8 (Instructions to Taxpayers), reflects the provision in Rev. Proc. 88-3 regarding this corporate recapitalization no-ruling area.

The Service is now aware that certain transactions not involving a closely-held corporation covered, or thought to be covered, by this no-ruling area are of sufficient significance or complexity to warrant issuance of a ruling letter. Accordingly, the Service will expand the scope of its ruling program with regard to these transactions.

SEC. 3. PROCEDURE

.01 Rev. Proc. 88-3 is modified by amending section 3.01(24) to read as follows:

> Section 368(a)(1)(E).—Definitions Relating to Corporate Reorganizations.—Whether a transaction constitutes a corporate recapitalization within the meaning of section 368(a)(1)(E) of the Code (or a transaction that also qualifies under section 1036) when either (i) the transaction involves a closely-held corporation or (ii) the issues involved are substantially similar to those described in the following revenue rulings:
>
> Rev. Rul. 82-34, 1982-1 C.B. 59 (continuity of business enterprise);
>
> Rev. Rul. 77-479, 1977-2 C.B. 119 (continuity of shareholder interest);
>
> Rev. Rul. 77-238, 1977-2 C.B. 115 (conversion of shares of one class of stock into shares of another class, as permitted by certificate of incorporation);
>
> Rev. Rul. 74-269, 1974-1 C.B. 87 (major shareholder's exchange of common stock for preferred stock);
>
> Rev. Rul. 56-654, 1956-2 C.B. 216 (corporate charter amended to provide preferred stock with increased redemption and liquidation value, where common and preferred stock held pro rata);
>
> Rev. Rul. 55-112, 1955-1 C.B. 344 (common stock exchanged for preferred stock); and
>
> Rev. Rul. 54-482, 1954-2 C.B. 148 (old common stock exchanged for new common stock).
>
> The above no-ruling area does not apply, however, to any corporate recapitalization that is an integral part of a larger transaction if it is impossible to determine the tax consequences of the larger transaction without making a determination with regard to the recapitalization.

.02 Rev. Proc. 88-1 is modified by deleting from the third paragraph of section 8.05 (dealing with specific guidelines for requesting rulings) the second sentence, which begins: "See, however, Rev. Proc. 88-3 . . . ." In place of this deleted sentence, the following sentence is substituted:

> See, however, Rev. Proc. 88-25, 1988-1 C.B. 803, which describes circumstances under which the Service will not issue advance rulings or determination letters as to whether a transaction constitutes a corporate recapitalization within the meaning of section 368(a)(1)(E) (or a transaction that also qualifies under section 1036).

SEC. 4. COMMENTS OR INQUIRIES

Comments or inquiries regarding this revenue procedure should be addressed to the Associate Chief Counsel (Technical and International), Attention: CC:C:3, Internal Revenue Service, 1111 Constitution Ave., N.W., Washington, D.C. 20224.

SEC. 5. EFFECT ON OTHER DOCUMENTS

Rev. Procs. 88-3 and 88-1 are modified.

SEC. 6. EFFECTIVE DATE

This revenue procedure is effective May 23, 1988, the date of its publication in the Internal Revenue Bulletin.

---

26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 103, 148; 1.103-1, 1.103-13.)

Rev. Proc. 88-26

SECTION 1. PURPOSE

This revenue procedure modifies section 4.01, paragraphs 4 and 7, of Rev. Proc. 88-3, page 579, this Bulletin, relating to areas under section 103 of the Code for which rulings will not ordinarily be issued by the Internal Revenue Service.

SEC. 2. BACKGROUND

Section 4 of Rev. Proc. 88-3 is titled "Areas in Which Rulings or Determination Letters Will Not Ordinarily Be Issued." Paragraphs 4 and 7 of section 4.01 are updated to reflect nonsubstantive changes resulting from the enactment of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 519.

SEC. 3. PROCEDURE

.01 Rev. Proc. 88-3 is updated by deleting paragraph 4 of section 4.01 and substituting in its place the following new paragraph:

> 4. Section 103.—Interest on State and Local Bonds.—Whether the interest on state and local bonds will be excludable from gross income under section 103(a) of the Internal Revenue Code if the proceeds of issues of bonds (other than advance refunding issues) are placed in escrow or otherwise not expended for a governmental purpose for an extended period of time even though the proceeds are invested at a yield that will not exceed the yield on the state and local bonds prior to their expenditure.

.02 Rev. Proc. 88-3 is updated by deleting paragraph 7 of section 4.01 and substituting in its place the following new paragraph:

> 7. Section 148.—Arbitrage.—Whether amounts received as proceeds from the sale of municipal bond financed property and pledged to the payment of debt service or pledged as collateral for the municipal bond issue are sinking fund proceeds within the meaning of section 1.103-13(g) of the Income Tax Regulations (issued under former section 103(c) of the Code) or replaced proceeds described in section 148(a)(2) of the Code (or former section 103 (c)(2)(B)).

SEC. 4. EFFECTIVE DATE

This revenue procedure is effective May 31, 1988, the date of publication of this revenue procedure in the Internal Revenue Bulletin.

SEC. 5. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 88-3 is modified.

---

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 88-27

SECTION 1. PURPOSE

This revenue procedure provides that no user fee is charged for earnings and profits determinations (Form 5452). It modifies Rev. proc. 88-8, page 628, this Bulletin, *as modified by* Rev. Proc. 88-13, page 639, this Bulletin, which requires the payment of a user fee for requests to the Internal Revenue Service for ruling letters, opinion letters, and determination letters and for similar requests.

SEC. 2. BACKGROUND

.01 Question N on page 3 of the Form 1120, U.S. Corporation Income Tax Return, instructs the corporate taxpayer, that, if during the year it paid dividends in excess of its current and accumulated earnings and profits, it must file Form 5452, Corporate Report of Nontaxable Dividends.

.02 Section 10511 of the Revenue Act of 1987 (Act), Pub. L. No. 100-203, 101 Stat. 1330, provides that the Secretary shall establish a program requiring the payment of user fees for requests to the Internal Revenue Service for ruling letters, opinion letters, and determination letters and for similar requests.

.03 Rev. Proc. 88-8 establishes such a program. It imposes a $200 fee for earnings and profits determination letters (Form 5452).

.04 After reconsideration, however, the Service has concluded that a Form 5452 is not subject to section 10511 of the Act because that form is neither a request for a ruling letter, opinion letter, or determination letter nor a similar request.

SEC. 3. PROCEDURES

.01 Section 4.031 of Rev. Proc. 88-8 is modified to delete the user fee of $200 for earnings and profits determinations (Form 5452). Section 4.031 of Rev. Proc. 88-8, as modified, reads as follows:

Applications with respect to accounting periods (Forms 1128 and 2553)	$150
Change in accounting method (Form 3115)................	$200
All other rulings (which includes accounting period, accounting method, and earnings and profits requests other than those submitted on Forms 1128, 2553, 3115, and 5452)......................	$300

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Section 4.031 of Rev. Proc. 88-8, is modified. When reprinted in the Cumulative Bulletin, Rev. Proc. 88-8 will incorporate this modification.

SEC. 5. EFFECTIVE DATE

This revenue procedure applies to all requests subject to Rev. Proc. 88-8, that is, to requests postmarked or, if not mailed, received on or after February 1, 1988. Any fees that have been paid for earnings and profits determinations (Form 5452) will be refunded.

---

26 CFR 601.602: Forms and instructions.
(Also Part I, Sections 408, 6041, 6041A, 6042, 6043, 6044, 6045, 6047, 6049, 6050A, 6050B, 6050D, 6050E, 6050H, 6050J, 6050N; 1.408-7, 1.6041-1, 1.6042-2, 1.6044-2, 1.6045-1, 1.6047-1, 1.6049-4, 1.6050A-1, 1.6050B-1, 1.6050D-1, 1.6050E-1, 1.6050H-1T, 1.6050J-1T.)

Rev. Proc. 88-28

PART A. GENERAL

SECTION 1. PURPOSE

.01 The purpose of this revenue procedure is to state the requirements for: (1) reproducing paper substitutes of the forms shown below, covering payments made during the 1988 calendar year (for Forms 5498, contributions made for 1988), that are required to be filed with the Internal Revenue Service (IRS), (2) furnishing substitute statements to form recipients (see Section 4.01 for definition, and paper document reporting). This revenue procedure contains specifications for the following:

(a) Form 1098, Mortgage Interest Statement.

(b) Form 1099-A, Information Return for Acquisition or Abandonment of Secured Property.

(c) Form 1099-B, Statement for Recipients of Proceeds From Broker and Barter Exchange Transactions.

(d) Form 1099-DIV, Statement for Recipients of Dividends and Distributions.

(e) Form 1099-G, Statement for Recipients of Certain Government Payments.

(f) Form 1099-INT, Statement for Recipients of Interest Income.

(g) Form 1099-MISC, Statement for Recipients of Miscellaneous Income.

(h) Form 1099-OID, Statement for Recipients of Original Issue Discount.

(i) Form 1099-PATR, Statement for Recipients (Patrons) of Taxable Distributions Received From Cooperatives.

(j) Form 1099-R, Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.

(k) Form 1099-S, Statement for Recipients of Proceeds From Real Estate Transactions.

(l) Form W-2G, Statement for Recipients of Certain Gambling Winnings.

(m) Form 5498, Individual Retirement Arrangement Information.

(n) Form 1096, Annual Summary and Transmittal of U.S. Information Returns.

.02 For the purpose of this revenue procedure, a substitute form is one that is not printed by IRS. For a substitute form to be acceptable to the IRS, it must conform to the official form and the specifications outlined in this revenue procedure. DO NOT submit any substitutes for APPROVAL. Only those forms that conform to the official form and comply with the specifications set forth herein are acceptable. See Part A, Section 8 for the specifications that apply to form recipient statements (Copy B).

.03 This revenue procedure supersedes Revenue Procedure 87-17.

SEC. 2. NATURE OF CHANGES

.01 Various editorial changes have been made.

.02 Chemical transfer paper no longer requires IRS approval.

.03 Form 1099-S, Statement for Recipients of Proceeds From Real Estate Transactions, has been added. In the past, real estate transactions were reported on Form 1099-B.

.04 A payee statement may be perforated to a check or to a statement of the payee's account. See section 8.01.

SEC. 3. REQUIREMENTS FOR ACCEPTABLE SUBSTITUTE FORMS 1096, 1098, 1099, 5498, and W-2G.

.01 Paper substitutes for Form 1096, and Copy A of Forms 1098, 1099, 5498, and W-2G, that totally conform to the specifications contained in this procedure may be privately printed and filed as returns with the IRS. DO NOT submit any substitutes for general approval. Only those forms that conform with the official form and the specifications contained herein are acceptable.

If you are uncertain of any specification set forth herein and want that specification clarified, you may submit a letter citing the specification in question, your interpretation of the specification, and an example of the form with your understanding of the specification to:

Internal Revenue Service
ATTN: TR:R:T
1111 Constitution Avenue, N.W.
Washington, DC 20224

.02 Copy B (Form 1098 For Payer, Form 1099-A For Borrower, other Forms 1099 For Recipient, Form 1099-S For Tansferor, Form 5498 For Participant), and Copy C (Form W-2G For Winner's Records) must contain the information specified in section 8 to rise to the level of a "statement" or "official form" under the applicable provisions of the Internal Revenue Code. The format of this information is at the discretion of the filer with the exception of the composite Form 1099 statement specified in section 8.04.

.03 Proposed substitutes for Copy A that do not conform to these specifications are not acceptable.

.04 No IRS office is authorized to allow deviations from this revenue procedure.

.05 IRS approval for the use of chemical transfer paper on Copy A is no longer required.

.06 Forms 1096, 1098, 1099, 5498, and W-2G are subject to annual review and possible change. Filers are cautioned, therefore, against overstocking supplies of privately printed substitutes. THE SPECIFICATIONS CONTAINED IN THIS REVENUE PROCEDURE APPLY TO 1988 FORMS ONLY.

.07 Copies of the official forms for the reporting year may be obtained from most Internal Revenue offices. IRS provides only cut sheets (no carbon interleaves) of these forms. If they are not available at your local IRS district office, you may ask them to order copies for you. You should receive your order within 10 days. If you prefer, you may order them by calling 1-800-424-Form.

.08 Only original or ribbon copies that are typed or machine printed with *black carbon based ink* may be filed with IRS. Carbon copies and photocopies are not acceptable.

SEC. 4. DEFINITONS

.01 The term "taxpayer (form recipient) identification number (TIN)" for an individual means the individual's social security number (SSN). The SSN consists of nine digits separated by hyphens as follows: 000-00-0000. For all other form recipients, the term "taxpayer (form recipient) identification number" means the employer identification number (EIN). The EIN consists of nine digits separated by one hyphen as follows: 00-0000000. For a sole proprietor, use the sole proprietor's SSN.

.02 In the past the terms payee and recipient were usually synonymous.

The addition of new forms to the information returns family requires different terminology to identify the recipient of a copy of the form filed with IRS *i.e.*, 1098 is payer/borrower, 1099-A is borrower, 1099S is transferor, 5498 is participant. Therefore, to prevent any confusion, the person who is required by law to receive a copy of the official form or information statement will be referred to as the "form recipient."

.03 The term "filer" means the person or organization required by law to file with IRS a form listed in section 1.01 above. A filer includes a payer, a recipient of mortgage interest payments, a broker, a barter exchange, a person reporting real estate transactions, a trustee or issuer of an individual retirement arrangement (including an IRA or SEP), and a lender who acquires an interest in secured property or who has reason to know that the property has been abandoned.

.04 A corrected and/or amended return is one that corrects previously reported information.

.05 The term "substitute form" means a paper substitute of Copy A of an official form listed in section 1.01 above that totally conforms to the provisions in this revenue procedure.

.06 The term "form recipient statement" means a paper statement of the information reported on a form listed in section 1.01 above that must be furnished to a person, (form recipient) as so defined under the applicable provisions of the Internal Revenue Code.

.07 A composite statement is a substitute form recipient copy of official Forms 1099-DIV, INT, OID and PATR, in the aggregate or in any combination thereof. A filer may use a composite statement when such reportable payments are paid to the same form recipient during the calendar year. A composite statement is one form (although the form itself may comprise more than one page) that contains all the requisite Form 1099 information (for Forms 1099-DIV, INT, OID, and PATR) A composite statement may contain any combination of the above Form 1099 information. A composite Form 1099 CANNOT be filed with IRS. If the filer does not use a composite statement for these payments, the filer must provide the necessary information to the form recipient separately on each respective form or substitute statement as the case may be.

SEC. 5. INSTRUCTIONS FOR PREPARING FORMS THAT WILL BE FILED WITH THE IRS

.01 The form recipient's name, street address, city, state, and ZIP code information must be TYPED OR MACHINE PRINTED IN BLACK INK on separate lines. The city, state, and ZIP code must be on the same line.

.02 The name of the appropriate form recipient must be shown on the first or second name line in the area on the form provided for the form recipient name and address. (See Section 6 for guidelines on the preferred methods for the form recipient name and TIN). No descriptive information or other name should precede the form recipient's name. ONLY one form recipient name should appear on the first line of the form. If more than one form recipient(s) name must be entered, we prefer that the filer place the responsible form recipient (person or organization whose TIN is provided) on the first line. Place other form recipients' names on the succeeding name lines (up to 2 name lines are allowable). While we prefer that these guidelines be followed in submitting information returns, we recognize that certain states require that the entities on trust accounts be provided in a different format. Filers should provide information returns reflecting payments to trust accounts with the trusts' TIN in the recipients' TIN areas, and the trusts' names as the recipients' first name lines and the trustee as the recipient's second name lines.

.03 The box below the form recipient's name and address may be used for the account number. This information is not required; however, special caution must be taken if an account number is being entered. This number must be unique and MUST NOT appear anywhere on the form other than in the box specified for this use. If window envelopes are used, this number must not show through the window because the Postal Service may not accept them for metered mail.

.04 Filers must TYPE OR MACHINE PRINT data entries on the forms, use carbon-base BLACK ribbon, insert data in the middle of blocks well separated from other printing and guidelines, and take other measures to guarantee a clear, dark black, sharp image.

.05 Machine printed forms should be printed using a 6 lines/inch option.

.06 Machine printed forms must be printed in 10 pitch pica (*i.e.*, 10 print characters per inch) or 12 pitch elite (*i.e.*, 12 print positions per inch).

.07 On corrected returns, an "X" must be placed within the check box located at the top of the form to the left of the word "CORRECTED." The accompanying Form 1096 for a submission of corrected returns should also contain an "X" within the "CORRECTED" box at the top of the form. DO NOT type the words CORRECTED RETURN on the Form 1096, 1098, 1099, 5498 or W-2G. All required data blocks must be completed on a corrected return since it replaces and supersedes the information return previously filed. Do not intermix corrected and original returns in a submission. Corrected returns should be filed separately.

.08 For corrected or voided documents, enter an "X" within the appropriate box using only computer print, typewriter or #2 pencil. DO NOT use a ball-point pen or felt tip marker. The machine used to "read" paper forms generally cannot "read" these ink types.

.09 Substitute forms prepared in continuous or strip form must be burst and stripped to conform to the size specified for a single sheet before they are filed with IRS. The size specified *does not include pinfeed holes*. Pinfeed holes MUST NOT be present on forms filed with IRS.

.10 Use decimal points to indicate dollars and cents. DO NOT use dollars signs ($), ampersands (&), asterisks(*), commas(,), or other special characters.

.11 DO NOT FOLD Forms 1096, 1098, 1099, or 5498 mailed to IRS. Mail these forms flat in an appropriately sized envelope or box. Folded documents cannot be readily moved through the scanner transport used in IRS processing.

.12 *DO NOT STAPLE* Forms 1096 to the returns being transmitted. Staple holes in the vicinity of the return code number reduce our ability to machine scan the return code number, which is used to identify the type of document being processed.

.13 MAIL completed paper forms to the IRS service center specified in the *1988 Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.*

.14 If you submit forms to IRS that do not meet the specifications in this revenue procedure, you may be subject to a penalty under section 6721 or 6723 of the Internal Revenue Code. The penalty is $50 for each form that the IRS cannot accept as a return because it does not meet the provisions set out in this revenue procedure.

.15 Filers who submit forms with missing or incorrect information (other than an SSN) on an information return may be subject to a penalty under section 6723 of the Internal Revenue Code. Generally the penalty is $5 per information return. For instructions on how to file information returns, see the *1988 Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.*

SEC. 6. TAXPAYER IDENTIFICATION NUMBERS

.01 Under section 6109 of the Internal Revenue Code, a person with respect to whom a return, statement, or other document is required to be made by another person must furnish his taxpayer identification number (TIN) to such other person. The number must be furnished to the filer whether or not the form recipient is required to file a tax return or is covered by Social Security. Section 6109 also requires filers to request the TINs and place them on returns required to be filed with IRS.

.02 Filers must provide correct TINs on all forms submitted. It is particularly important that correct social security and employer identification numbers for form recipients be provided on magnetic media or paper forms submitted to IRS.

.03 Section 6676 of the Internal Revenue Code imposes a $50 penalty on filers for each return filed with an incorrect or missing TIN. For payments of interest, dividends, patronage and original issue discount the penalty is self-assessable on Form 8210, Self-Assessed Penalties Return.

.04 The TIN required to be furnished to the IRS depends primarily on the manner in which the account is maintained in the filer's records. Usually, the TIN provided must be that of the owner of record. If an account is recorded as a joint account, *i.e.*, more than one person is listed on the account, furnish the TIN and name of the first person listed on the record. For individuals, recipients, including sole proprietors, the TIN is the SSN. For other entities, furnish an EIN.

.05 Sole proprietors filing information returns should show their EIN on the return if required to have an EIN. If not, they should show their SSN.

.06 The charts below will help you determine the TIN to be furnished to IRS.

Chart 1. Guidelines for Social Security Numbers

Type of account	For Form Recipient TIN enter the Social Security number of	On the 1st Name Line of the Form Recipient Portion of the Return Enter the Name of
1. Individual account.	The individual.	The individual.
2. Joint account (two or more individuals, husband and wife, adult and minor).	The actual owner of account. (If more than one owner, the first individual on the account).	The individual whose SSN is entered.
3. Account in the name of a guardian or committee for a designated ward, minor, or incompetent person.	The ward, minor, or incompetent person.	The individual whose SSN is entered.
4. Custodian account of a minor (Uniform Gift to Minors Act).	The minor.	The minor.
5. The usual revocable savings trust account (grantor is also trustee).	The grantor-trustee.	The grantor-trustee.
6. So-called trust account that is not a legal or valid trust under state law.	The actual owner.	The actual owner.
7. Sole proprietorship.	The sole proprietor owner.	The sole proprietor owner.

Chart 2. Guidelines for Employer Identification Numbers

For this type of account	For Form Recipient TIN enter the Employer Identification Number of	On the 1st Name Line of the Form Recipient Portion of the Return Enter the Name of
1. A valid trust, estate, or pension trust.	Legal entity. (Do not furnish the identification number of the personal representative or trustee unless the name of the representative or trustee is used in the account title).	The legal trust, estate, or pension trust.
2. A corporate account.	The corporation.	The corporation.
3. An association, club, religious, charitable, educational, or other tax-exempt organization.	The organization.	The organization.
4. A partnership account held in the name of the business.	The partnership.	The partnership.
5. A broker or registered nominee middleman.	The broker or nominee/middleman.	The broker or nominee/middleman.
6. Account with the Department of Agriculture in the name of a public entity, such as a state or local government, school district, or prison, that receives agriculture program payments.	The public entity.	The public entity.

SEC. 7. MAGNETIC MEDIA FILING

.01 IRS encourages all filers including nominees (hereafter collectively referred to as filers) to file information returns on magnetic media instead of paper forms. All forms listed in Sec. 1.01 (except Form 1096) may be filed on magnetic media.

.02 Any person who is required to file, or was required to file for the prior year, more than 50 Forms 1099-DIV (for dividends reportable under section 6042 of the Code), 1099-INT, 1099-OID, or 1099-PATR in any combination, for a calendar year MUST file these returns on magnetic media. This requirement applies to any person for any period unless such person establishes that this requirement would result in undue hardship and requests a waiver from the filing requirements. To request a waiver from filing on magnetic media, submit a waiver request on a written statement or on Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media, 90 days before the due date of the return and send it to the following address: Internal Revenue Service, National Computer Center, P.O. Box 1359, Martinsburg, WV 25401-1359.

.03 Regulations section 1.6045-1(1) requires brokers and barter exchanges to use magnetic media in reporting any Form 1099-B data to IRS. Generally, new brokers and new barter exchanges may request an undue hardship exception by filing a waiver request by the end of the second month following the month in which they became a broker or barter exchange, at the address in .02 above.

.04 You are required to use magnetic media for filing Forms 1098, 1099-A, 1099-G, 1099-MISC (except substitute payments reported in Box 8), 1099-R, 1099-S, 5498, and W-2G if you are required to file, or were required to file for the prior year, 250 or more returns unless you establish that this requirement would result in undue hardship. A request for a waiver should be submitted by written statement or on Form 8508, 90 days before the due date of the return and sent to the National Computer Center, at the address in .02 above.

.05 Specifications for filing information returns on magnetic tape, 9 inch, 5 1/4 inch diskette, and 3 1/2 inch diskette are contained in various revenue procedures relating to Requirements and Conditions for Filing Information Returns on Magnetic Media. Copies of these procedures may be obtained from any Internal Revenue district office or by writing to the address in .02 above or calling (304) 263-8700 (not a toll-free number). Filers or agents who are required to, or want to, file information returns on magnetic media must file Form 4419, Application for Information Returns Filing on Magnetic Media. Forms 4419 must be filed prior to submitting returns on magnetic media. IRS will provide a written reply to the applicant and further instructions at the time of approval. The application must be sent to the National Computer Center address in .02 above.

.06 Since many states accept information returns filed on magnetic media, savings may be obtained if similar media is used for filing with IRS and state tax agencies. For information regarding state magnetic media filing requirements, filers should contact the respective state tax authority.

SEC. 8. STATEMENT TO FORM RECIPIENTS AND FORM RECIPIENT COPIES

.01 For payments of interest and dividends reportable on Forms 1099-DIV (for dividends reportable under section 6042 of the IRC), 1099-INT (except for interest reportable under section 6041), 1099-OID, or 1099-PATR, an official Form 1099 must be furnished to a form recipient either in a statement mailing by first-class mail or in person. For payments of royalties reportable on Form 1099-MISC, you are also required to furnish the statement in person or in a statement mailing by first-class mail, but the statement need not be the official form. These forms may be mailed or provided to the form recipient in one of two ways: (1) in a statement mailing with other Forms 1098, 1099 or 5498 form recipient statements, a check, a letter explaining why no check is enclosed, a statement of the person's account, Forms W-8 and W-9, Forms W-2 and W-2P, and a letter limited to an explanation of the tax consequences of the enclosed form recipient statements. A form recipient statement may be perforated to a check with respect to the account reported on the payee statement or to a statement of the payee's specific account if payments on such account are reflected on the form recipient statement. The enclosure to which the form recipient statement is perforated must contain, in a bold and conspicuous type the legend "Important Tax Return Document Attached." If this method is used, the statement "Important Tax Return Document Enclosed" must appear on the outside of the envelope and on each check, letter, or account statement in a bold and conspicuous manner. (2) In a separate mailing with other Forms 1098, 1099, or 5498 form recipient statements, Forms W-8 and, W-9 Forms W-2 and W-2P, and a letter of the tax consequences of the enclosed form recipient statements. If you follow the second method you are not required to include the legend "Important Tax Return Document Enclosed" on the envelope. NOTE: Applies to (1) and (2), No other information, such as advertising, promotional material, or a quarterly or annual report, may be mailed with the form recipient statement or provided in person with the form recipient statement without violating these requirements. See Notice 87-17, 1987-1 C.B. 454, and other applicable procedures for the rules on how these statements should be provided to form recipients.

.02 The requirement to furnish form recipients with an official Form 1099-DIV, INT, OID, and PATR, may be met by furnishing a substitute Form 1099 (form recipient statement) if it contains language substantially similar to that of the official IRS form, such as the aggregate amount paid to the form recipient, any Federal income tax withheld under IRC section 3406 of the Code, the name, address, and TIN of the person making the return, and any other information required by the official form. Generally, information not required by the official form should not be included on the form because it may violate the mailing requirements (see .01 above). In addition, the form recipient statement for interest, dividends, patronage dividends, and original issue discount must contain the information listed below.

1 All money amounts required to be reported to the form recipient must be titled and numbered in substantially the same manner as those on the official IRS form.

2 The form recipient statement must contain all applicable form recipient instructions provided on the front and back of the official IRS form.

3 Form recipient statement covering reportable interest, dividends, patronage dividends, and original issue discount must contain the following statement in bold and conspicuous type, "**This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this income is taxable and IRS determines that it has not been reported.**"

4 The form recipient statement must contain the Office of Management and Budget (OMB) number as shown on the official IRS form.

5 The form recipient statement must show the title and number of the official IRS Form 1099 for which it substitutes.

.03 If the form recipient statement contains all the information listed in .02 above, layout and format of the form is at the discretion of the filer.

.04 A composite form recipient statement is permitted for reportable payments of interest, dividends, patronage dividends, and/or original issue discount (Forms 1099-DIV, INT, OID or PATR) when one filer is reporting any or all of these payments during a calendar year to the same form recipient. Although the composite form recipient statement may be on one form, the format of the composite form recipient statement must satisfy the following requirements in addition to the requirements listed in .02 above.

1 All information pertaining to a particular type of payment must be located and blocked together on the form and must be separate from any information covering other types of payments included on the form.

2 The title of the official IRS form or forms for which this form recipient statement substitutes must be shown at the beginning of each appropriate block of information.

3 Any information required by the official IRS form that would otherwise be repeated in each information block is only required to be listed once in the first information block on the composite form. For example, there is no requirement to report the name of the filer in each information block.

.05 Statements to form recipients of other reportable payments on Forms 1098, 1099-A, 1099-B, 1099-G, 1099-MISC (except payments reportable under section 6045), 1099-R, 1099-S, 5498, 1099-DIV (or payments reportable under section 6047), 1099-INT (for payments reportable under section 6041) and W-2G should meet the following requirements:

1. The filer and form recipient information required on the official IRS form must be included.
2. All money amounts and information required to be reported to the form recipient must be titled on the form recipient statement in substantially the same manner as those on the official IRS form.
3. Form recipient statements must contain the following:

    (1) Forms 5498 and Form 1099-R—"This is important tax information and is being furnished to the Internal Revenue Service."

    (2) Forms 1099-G and W-2G—"This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported."

    (3) Forms 1099-B and 1099-MISC—Same as item (2) above, except change "may" to "will" in the second sentence.

    (4) Form 1099-A—"This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported."

    (5) Form 1098—(a) "This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if the IRS determines that an underpayment of tax results because you overstated a deduction for this mortgage interest on your return."

    (b) "The amount shown may not be fully deductible by you on your Federal income tax return. Limitations based on the cost and value of the secured property may apply. In addition, you may only deduct an amount of mortgage interest to the extent it was incurred by you, actually paid by you, and not reimbursed by another person."

    NOTE: The language contained in 5(a) differs from the 1988 official IRS Form 1098. You may choose to use the legend as shown on the official IRS form in place of 5(a).

    (6) Form 1099-S any written statement must contain the following: "This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanctions will be imposed on you if this item is required to be reported and the IRS determines that it has not been reported.

    NOTE: You may use a Uniform Settlement Statement (under RESPA) as the written statement if it is conformed by designating on the statement the legend described above and that information reported to IRS on Form 1099-S.

4. Appropriate instructions to the form recipient, similar to those on the official IRS form, must be provided to aid in the proper reporting of the items on the form recipient's income tax return. For payments reported on Form 1099-B, the requirement to include on the statement furnished to form recipients instructions that are substantially similar to those on the official IRS form may be satisfied by providing form recipient with a single set of instructions with respect to all statements required to be furnished in a calendar year.

.06 Form recipient statements specified in .05 above may contain information other than that required by the official IRS form. However, if other information is included, such statements cannot mailed with Forms 1099-DIV, INT, OID, or PATR or their substitutes without violating the statement mailing requirements.

.07 A composite form recipient statement for forms specified in .05 above is permitted when one filer is reporting any or all of these payments during a calendar year to the same form recipient. A composite statement is not allowable for a combination of forms listed in .05 above and forms listed in .04 above. For example, a composite statement of Form 1098 and 1099-INT (for interest reportable under section 6049) is not allowable. Although the composite form recipient statement may be on one form, the format of the composite form recipient statement must satisfy the requirements listed in items (1), (2), and (3) of .04 above.

PART B. SUBSTITUTE FORM FORMAT REQUIREMENTS (EXCLUDING FORM W-2G)

SEC. 1. GENERAL

.01 The following specifications prescribe the format requirements of Forms 1098 (Copy A), 1099 (Copy A), 5498 (Copy A), and 1096.

.02 The form identifying number (*e.g.*, 9191 for Forms 1099-DIV) must be printed in non-reflective black carbon-based ink in print positions 25 through 29 using an OCR A font. The ballot boxes located to the right of the form identifying number must be 10-point boxes.

NOTE: If the ballot box is checked indicating a corrected return or a "void" return, more than 50% of the box must be covered by an "X." Do not type "CORRECTED RETURN" on the top of the form. All required data must be completed on the corrected form since it replaces and supersedes the information return previously filed.

SEC. 2. SPECIFICATIONS FOR FORMS 1096 AND COPY A OF FORMS 1098, 1099 AND 5498

.01 The substitute form must be an exact replica of the official IRS reproduction proof with respect to layout and contents. "Spot Carbons" are *not permitted* for Copy A. The Government Printing Office (GPO) symbol must be deleted. Specifications for Copy A are provided in Exhibits A thru N.

.02 Color and quality of paper. Paper for Copy A (cut sheets and continuous pinfeed forms) as specified by JCP Code 0-25, dated November 29, 1978, must be White 100% bleached chemical wood, optical character recognition (OCR) bond produced in accordance with the following specifications:

NOTE: Reclaimed fiber in any percentage is permitted, provided the requirements of this standard are met.

1 Acidity: pH value, average,
  not less than 4.5
2 Basis Weight 17 × 22
  500 cut sheets 20
  Metric equivalent—g/m2..... 75
  A Tolerance of ±5 pct.
  shall be allowed.
3 Stiffness: Average, each
  direction, not less
  than—milligrams............ 50
4 Tearing strength: Average,
  each direction, not less
  than—grams 40
5 Opacity: Average, not less
  than—percent 82
6 Thickness: Average—
  inch—0.0038
  Metric equivalent—
  mm—0.097
  A tolerance of +0.0005 inch (0.0127 mm) shall be allowed. Paper shall not vary more than 0.0004 inch (0.0102 mm) from one edge to the other.
7 Porosity: Average, not less
  than—seconds 10
8 Finish (smoothness): Average,
  each side—seconds....... 20-55
  For information only,
  the Sheffield
  equivalent—units 170-100
9 Dirt: Average, each side,
  not to exceed—parts
  per million.................. 8

.03 All printing will be in red OCR dropout ink, as specified, except for the 4-digit form identifying numbers appearing in the upper middle margin on the official IRS form, which will be printed in nonreflective carbon-based black ink. All other printing will be in red OCR dropout ink with or comparable to the specifications below. The screened area of any substitute form should generally correspond to that present on the official form. Separation between fields must be 0.1 inch. The numbered captions are printed as a solid with no screened background. The red OCR dropout ink must be Sinclair-Valentine J-6983 or an exact match.

OCR Specifications

Contractor must have or initiate a quality control program to assure OCR ink density. In addition he must have at or adjacent to his production area either a MacBeth PCM-II tester or a Kidder 082A tester in order that testing may be accomplished at regular intervals throughout a shift.

Paper and Ink

Readings will be made when printed on approved 20 lb. White OCR bond with a reflectance of not less than 80%. Black ink must not have a reflectance greater than 15%. These readings are based on requirements of the "REI Input 80 Model C1 & D" Optical Scanner using Sinclair and Valentine J-6983 red ink or equal.

MacBeth PCM II Tester

The tested Print Contrast Signal (PCS) values when using the MacBeth PCM-II tester on the "C" scale must range from .01 minimum to .06 maximum.

Kidder 082A Tester

The tested Print Contrast Signal (PCS) values when using the Kidder 082A tester on the Infra Red (IR) scale must range from .12 minimum to .21 maximum. White calibration disc must be 100%, sensitivity must be set at one (1).

Alternative Tester

If an alternative tester is used it must be approved by the Government so that tested (PCS) values can be established with this equipment. Approval may be obtained by writing to the following address:

Commissioner of Internal Revenue
Attn: HR:F:P:P Room 1237
Tax Forms Procurement Analyst
1111 Constitution Avenue, N.W.
Washington, DC 20224

Printing exceeding the maximum screen density will cause the forms to be nonprocessable. If this happens the filer will be required to refile on acceptable forms and will be subject to a $50 penalty for each form printed or prepared that is filed in a nonprocessable format.

.04 Typography—Type must be substantially identical in size and shape with corresponding type on the **official form. All rules are either 1/2-point or 3/4-point. Rules must be identical to that on the official IRS form.**

NOTE: The form identifying number must be nonreflective carbon-based black ink in OCR A font.

.05 Dimension—Three official Forms 1098, 1099 or 5498 (Copy A) are contained on a single page, which is 8 inches wide (exclusive of any snapstubs and/or pinfeed holes) by 11 inches deep. The top margins must be 2/6 inch, and the right margin must be 1/4 inch plus or minus .0313 inch. If the right and top margins are properly aligned the left margin for all forms will be correct. All margins must be free of all printing.

Note: The image size of Forms 1099-S will be 1/6 of an inch shorter than the other Forms 1099, 1098, or 5498. See Exhibit K for specifications.

.06 The depth of the individual trim size of each form on a page must be the same (3 2/3 inches) as that of the official form.

.07 Perforations are required between forms on all copies except Copy A to enable the separation of individual forms.

.08 The words "For Paperwork Reduction Act Notice and instructions for completing this form, see *Instructions for Forms 1099, 1098, 5498, 1096 and W-2G must* be printed on Copy A and Copy C.

.09 The OMB Number *must* be printed on *each* ply in the same location as on the official form.

.10 *Privately printed continuous substitute forms (Copy A) must be perforated at each 11" (3-on) page depth. No perforations are allowed between the 3 2/3" forms on a single copy page of Copy A.*

.11 The words "Do NOT Cut or Separate Forms on This Page" must be printed in red dropout ink (as required by form specifications) between the three forms. NOTE: Performations are required between all the other individual copies (Copies B and C, and Copies 1 and 2 for Form 1099-R) included in the set.

.12 The back of a substitute Copy A must be free of all printing.

.13 Carbonized. *"Spot carbons"* are *not permitted* for Copy A. Interleaved carbon must be of good quality to assure legibility of information on all parts to preclude smudging and should be black. "Chemical transfer paper" is now permitted without IRS approval.

.14 Printer's symbol—The GPO symbol must not be placed on substitute Copy A. *In place of the GPO symbol*, the employer identification number (EIN) of the forms printer must be printed in the bottom margin on the face of each individual form of Copy A.

.15 A postal indicia may be used if it meets the following criteria: a) it is printed in the OCR ink color prescribed for the form; b) no part of the indicia is within 1 print position of the scannable area; c) there is a 2/6 inch head margin; and d) there is a 1/4 inch right margin.

PART C. SUBSTITUTE FORM FORMAT REQUIREMENTS FOR FORM W-2G ONLY

SEC. 1. GENERAL

.01 The following specifications prescribe the format requirements of Form W-2G—COPY A ONLY

.02 A filer may file a substitute Form W-2G with IRS (hereinafter referred to as substitute Copy A). Substitute forms submitted to IRS must be exact replicas of the official forms with respect to layout and contents. The Government Printing Office symbol must be deleted.

SEC. 2. SPECIFICATIONS FOR COPY A FOR FORMS W-2G

.01 Color and Quality of Paper.

1 Paper for Copy A must be white chemical wood bond, or equivalent, 20 pound (basis 17 x 22-500), plus or minus 5 percent. The paper must consist of principally bleached chemical woodpulp and be free from unbleached or ground woodpulp or recycled printed paper. It also must be suitably sized to accept ink without feathering.

2 Copies B and C (to be filed with tax return and For Winner's Records) and D (For Payer) are provided in the official assembly solely for the convenience of the filer. Filers may choose the format, design, color and quantity of the paper used for these copies.

3 Copies 1 and 2 are provided to file with the state. Some states have requested the addition of these two plys and they have been included solely for the convenience of the filer.

.02 Color and Quality of Ink—All printing must be in a high quality non-gloss black ink. Bar codes should be free from picks and voids.

.03 Typography—Type must be substantially identical in size and shape with corresponding type on the official form. All rules on the document are either 1/2 point (.007 inch), 1 point (0.015 inch) or 3 point (0.045). Vertical rules must be parallel to the left edge of the document; horizontal rules, parallel to the top edge.

.04 Dimensions—The official form is 8 inches wide × 3 2/3 inches deep, exclusive of a 2/3 inch snap stub on the left side of the form. The snap feature is not required on substitutes. The top and right margins must be 1/4 inch plus or minus .0313. If the top and right margins are properly aligned, the left margin for all forms will be correct. All margins must be free of all printing. If the substitute forms are in continuous or strip form, they must be burst and stripped to conform to the size specified for a single form before they are filed with IRS.

1 The width of a substitute Copy A must be 8 inches. The left margin must be free of all printing other than that shown on the official form.

2 The depth of a substitute Copy A must be 3 2/3 inches.

.05 Clear Area—The back of Copy A must be free of all printing.

.06 Carbonized forms or "spot carbons"—Carbonized forms and "spot carbons" are not permitted. Interleaved carbons, if used, must be of good quality to preclude smudging and should be black.

.07-Printer's Symbol—The Government Printing Office symbol must not be printed on substitute Forms W-2G. In place thereof, the printer's employer identification number should appear in the same place on such substitute forms.

PART D. ADDITIONAL INSTRUCTIONS FOR FORMS 1098, 1099, 5498, and W-2G

SEC. 1. OTHER COPIES

.01 Copies 1 and 2, B, C, and D are included in the official assembly for the convenience of the filer. Although there is no requirement that privately printed substitute forms include these copies, Copies B and C will satisfy the requirement of law and regulations concerning the statement of information that is required to be furnished to the form recipient. Copies C and D may be desired as a filer record copy.

.02 Arrangement of Assembly—The parts of the assembly shall be arranged, from top to bottom, as follows: Forms 1099 (Except 1098, 1099-A, 1099-R, 1099-S, 5498, and W-2G) Copy A (Original), "For Internal Revenue Service Center"; Copy B "For Recipient"; Copy C "For Payer". Form 1098 (Copy A (original), "For Internal Revenue Service Center"; Copy B "For Payer"; Copy C "For Recipient." Form 1099-A Copy A (Original), "For Internal Revenue Service Center"; Copy B "For Borrower"; Copy C "For Lender." Form 1099-R Copy A (Original), "For Internal Revenue Service", Copy 1, "For State Tax Department"; Copy B, "For Recipient"; Copy 2, "To be filed with recipient's state income tax return when required."; Copy C, "For Payer". Form 1099-S Copy A (original), "For Internal Revenue Service Center"; Copy B, "For Transferor"; Copy C, "For Filer." Form 5498 Copy A (Original), "For Internal Revenue Service Center", Copy B "For Participant"; Copy C "For Trustee or Issuer." Form W-2G Copy A (Original), "For Internal Revenue Service Center"; Copy 1, "For State Tax Department"; Copy B and C "For Winner's Records"; Copy 2 "To be filed with winner's state income tax return, if required.", Copy D "For Payer."

SEC. 2. REPRODUCTION PROOFS

.01 Reproduction Proofs—Order blanks for reproduction proofs are mailed annually to requestors of record and to other users upon request. Printers and others wishing to obtain reproduction proofs may send their requests to:

Internal Revenue Service
Attn: Reproduction Proof
Coordinator
HR:F:P:—Room 1528
1111 Constitution Avenue, N.W.
Washington, DC 20224

.02 A charge of $1.00 per printed page will be made for each reproduction proof regardless of page size. Invoices will be made after orders are filled.

SEC. 3. OMB REQUIREMENTS

.01 Office of Management and Budget (OMB) Requirements for Substitute Forms—Pub. L. 96-511 requires: (1) OMB approval of Internal Revenue Service tax forms, (2) that each form show (in the upper right corner) the OMB approval number, and (3) the form (or its instructions) state why IRS is collecting the information, how it will be used and whether it must be given to us. The official IRS forms or instructions will contain this information.

.02 As it applies to substitute IRS forms this means:

1 All substitute forms must show the OMB number as it appears on the official IRS form.

2 For Copy A, the OMB number must appear exactly as shown on the official IRS form.

3 For any copy other than Copy A, the OMB number must use one of the following formats:

a OMB No. XXXX-XXXX (preferred) or;

b OMB # XXXX-XXXX

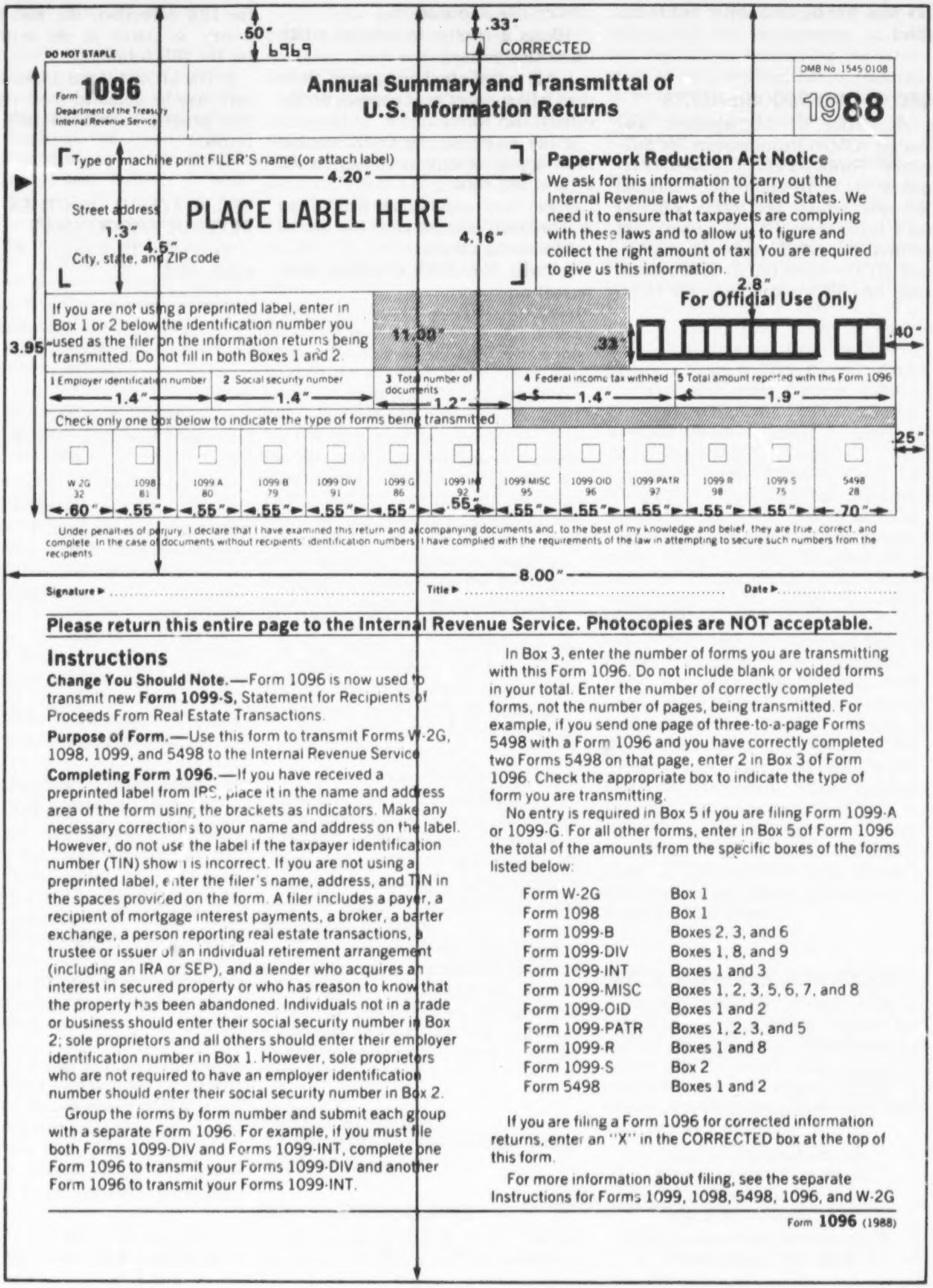
4 You must inform the users of your substitute forms of the reasons for IRS collection, use and requirements, as stated in the instructions for the IRS form.

5 The official OMB approval numbers may be obtained from reproduction proofs, or official IRS printed forms.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Revenue Procedure 87-17 is superseded.

Exhibit A


.60"
.33"
4.20"
1.3"
4.5"
4.16"
2.8"
3.95
11.00"
.33"
.40"
1.4"
1.4"
1.2"
1.4"
1.9"
.25"
.60"
.55"
.55"
.55"
.55"
.55"
.55"
.55"
.55"
.55"
.55"
.55"
.70"
8.00"

6969

☐ CORRECTED

DO NOT STAPLE

Form **1096**
Department of the Treasury
Internal Revenue Service

Annual Summary and Transmittal of U.S. Information Returns

OMB No 1545 0108

1988

Type or machine print FILER'S name (or attach label)

Street address

PLACE LABEL HERE

City, state, and ZIP code

Paperwork Reduction Act Notice

We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

For Official Use Only

If you are not using a preprinted label, enter in Box 1 or 2 below the identification number you used as the filer on the information returns being transmitted. Do not fill in both Boxes 1 and 2.

1 Employer identification number	2 Social security number	3 Total number of documents	4 Federal income tax withheld	5 Total amount reported with this Form 1096
			$	$

Check only one box below to indicate the type of forms being transmitted.

☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
W-2G 32	1098 81	1099-A 80	1099-B 79	1099-DIV 91	1099-G 86	1099-INT 92	1099-MISC 95	1099-OID 96	1099-PATR 97	1099-R 98	1099-S 75	5498 28

Under penalties of perjury, I declare that I have examined this return and accompanying documents and, to the best of my knowledge and belief, they are true, correct, and complete. In the case of documents without recipients' identification numbers, I have complied with the requirements of the law in attempting to secure such numbers from the recipients.

Signature ▶ .... Title ▶ .... Date ▶ ....

Please return this entire page to the Internal Revenue Service. Photocopies are NOT acceptable.

Instructions

Change You Should Note.—Form 1096 is now used to transmit new **Form 1099-S,** Statement for Recipients of Proceeds From Real Estate Transactions.

Purpose of Form.—Use this form to transmit Forms W-2G, 1098, 1099, and 5498 to the Internal Revenue Service.

Completing Form 1096.—If you have received a preprinted label from IRS, place it in the name and address area of the form using the brackets as indicators. Make any necessary corrections to your name and address on the label. However, do not use the label if the taxpayer identification number (TIN) shown is incorrect. If you are not using a preprinted label, enter the filer's name, address, and TIN in the spaces provided on the form. A filer includes a payer, a recipient of mortgage interest payments, a broker, a barter exchange, a person reporting real estate transactions, a trustee or issuer of an individual retirement arrangement (including an IRA or SEP), and a lender who acquires an interest in secured property or who has reason to know that the property has been abandoned. Individuals not in a trade or business should enter their social security number in Box 2; sole proprietors and all others should enter their employer identification number in Box 1. However, sole proprietors who are not required to have an employer identification number should enter their social security number in Box 2.

Group the forms by form number and submit each group with a separate Form 1096. For example, if you must file both Forms 1099-DIV and Forms 1099-INT, complete one Form 1096 to transmit your Forms 1099-DIV and another Form 1096 to transmit your Forms 1099-INT.

In Box 3, enter the number of forms you are transmitting with this Form 1096. Do not include blank or voided forms in your total. Enter the number of correctly completed forms, not the number of pages, being transmitted. For example, if you send one page of three-to-a-page Forms 5498 with a Form 1096 and you have correctly completed two Forms 5498 on that page, enter 2 in Box 3 of Form 1096. Check the appropriate box to indicate the type of form you are transmitting.

No entry is required in Box 5 if you are filing Form 1099-A or 1099-G. For all other forms, enter in Box 5 of Form 1096 the total of the amounts from the specific boxes of the forms listed below:

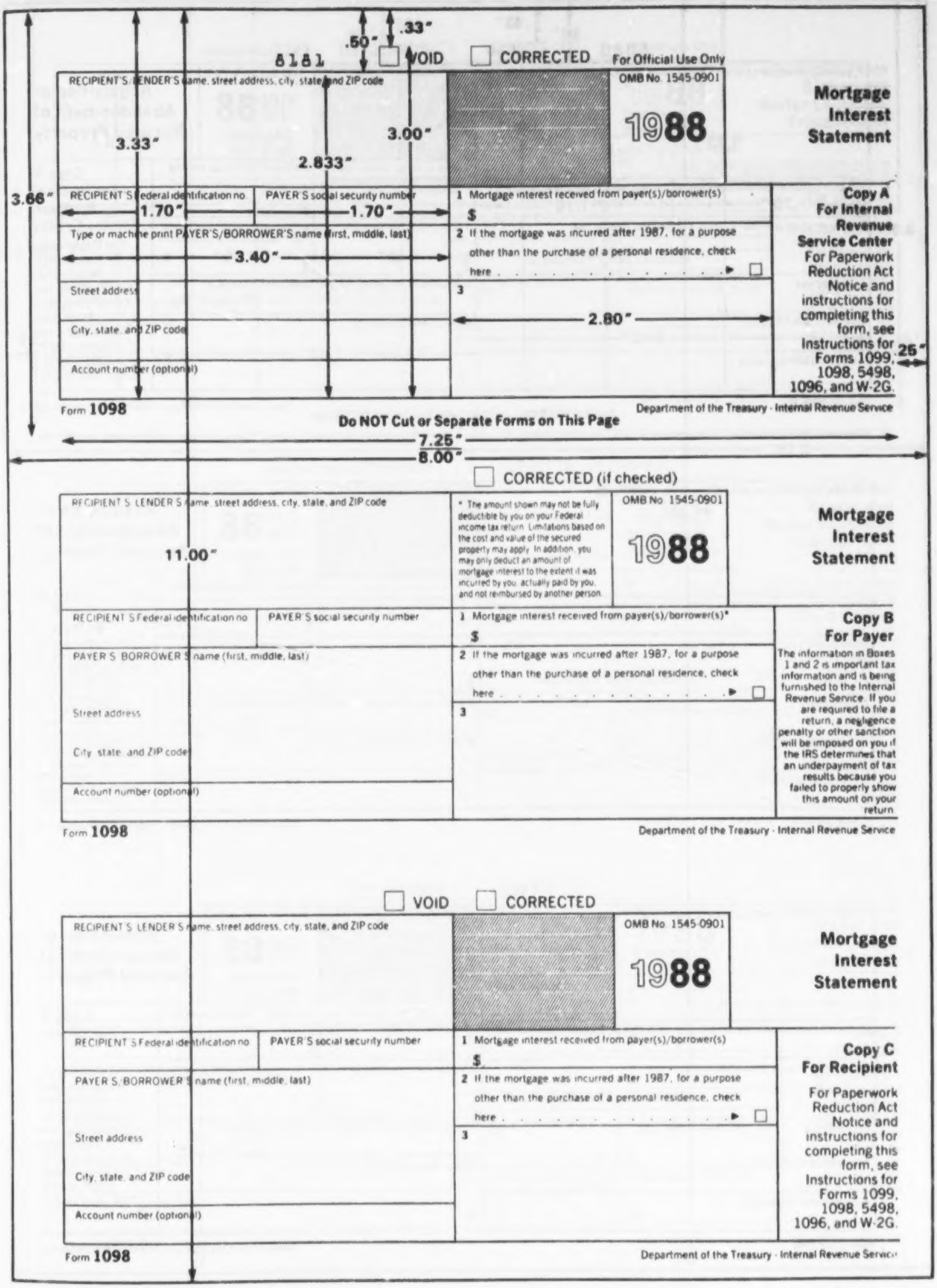
Form W-2G	Box 1
Form 1098	Box 1
Form 1099-B	Boxes 2, 3, and 6
Form 1099-DIV	Boxes 1, 8, and 9
Form 1099-INT	Boxes 1 and 3
Form 1099-MISC	Boxes 1, 2, 3, 5, 6, 7, and 8
Form 1099-OID	Boxes 1 and 2
Form 1099-PATR	Boxes 1, 2, 3, and 5
Form 1099-R	Boxes 1 and 8
Form 1099-S	Box 2
Form 5498	Boxes 1 and 2

If you are filing a Form 1096 for corrected information returns, enter an "X" in the CORRECTED box at the top of this form.

For more information about filing, see the separate Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1096** (1988)

Exhibit B



8181 ☐ VOID ☐ CORRECTED For Official Use Only

RECIPIENT'S/LENDER'S name, street address, city, state, and ZIP code	▨	OMB No. 1545-0901 1988	**Mortgage Interest Statement**
RECIPIENT'S Federal identification no. / PAYER'S social security number	1 Mortgage interest received from payer(s)/borrower(s) $		**Copy A For Internal Revenue Service Center** For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.
Type or machine print PAYER'S/BORROWER'S name (first, middle, last)	2 If the mortgage was incurred after 1987, for a purpose other than the purchase of a personal residence, check here . . . . ▶ ☐		
Street address	3		
City, state, and ZIP code			
Account number (optional)			

Form **1098** Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

☐ CORRECTED (if checked)

RECIPIENT'S/LENDER'S name, street address, city, state, and ZIP code	* The amount shown may not be fully deductible by you on your Federal income tax return. Limitations based on the cost and value of the secured property may apply. In addition, you may only deduct an amount of mortgage interest to the extent it was incurred by you, actually paid by you, and not reimbursed by another person.	OMB No. 1545-0901 1988	**Mortgage Interest Statement**
RECIPIENT'S Federal identification no. / PAYER'S social security number	1 Mortgage interest received from payer(s)/borrower(s)* $		**Copy B For Payer** The information in Boxes 1 and 2 is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if the IRS determines that an underpayment of tax results because you failed to properly show this amount on your return.
PAYER'S/BORROWER'S name (first, middle, last)	2 If the mortgage was incurred after 1987, for a purpose other than the purchase of a personal residence, check here . . . . ▶ ☐		
Street address	3		
City, state, and ZIP code			
Account number (optional)			

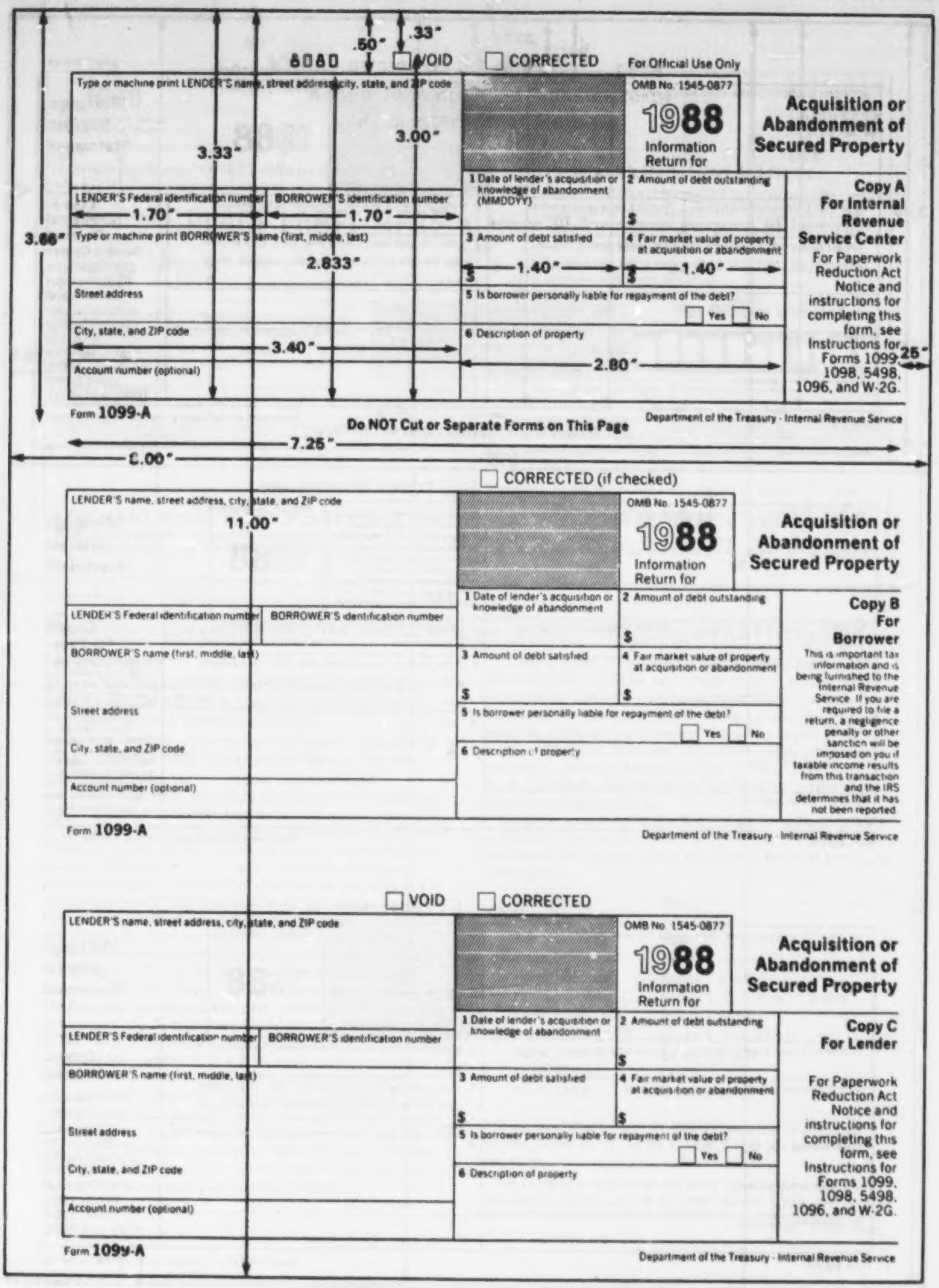
Form **1098** Department of the Treasury - Internal Revenue Service

☐ VOID ☐ CORRECTED

RECIPIENT'S/LENDER'S name, street address, city, state, and ZIP code	▨	OMB No. 1545-0901 1988	**Mortgage Interest Statement**
RECIPIENT'S Federal identification no. / PAYER'S social security number	1 Mortgage interest received from payer(s)/borrower(s) $		**Copy C For Recipient** For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.
PAYER'S/BORROWER'S name (first, middle, last)	2 If the mortgage was incurred after 1987, for a purpose other than the purchase of a personal residence, check here . . . . ▶ ☐		
Street address	3		
City, state, and ZIP code			
Account number (optional)			

Form **1098** Department of the Treasury - Internal Revenue Service

Exhibit C



8080 ☐ VOID ☐ CORRECTED For Official Use Only

Type or machine print LENDER'S name, street address, city, state, and ZIP code

OMB No. 1545-0877

1988

Information Return for

Acquisition or Abandonment of Secured Property

LENDER'S Federal identification number

BORROWER'S identification number

1 Date of lender's acquisition or knowledge of abandonment (MMDDYY)

2 Amount of debt outstanding $

Type or machine print BORROWER'S name (first, middle, last)

3 Amount of debt satisfied $

4 Fair market value of property at acquisition or abandonment $

Street address

5 Is borrower personally liable for repayment of the debt? ☐ Yes ☐ No

City, state, and ZIP code

6 Description of property

Account number (optional)

Copy A For Internal Revenue Service Center

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-A**

Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

☐ CORRECTED (if checked)

LENDER'S name, street address, city, state, and ZIP code

OMB No. 1545-0877

1988

Information Return for

Acquisition or Abandonment of Secured Property

LENDER'S Federal identification number

BORROWER'S identification number

1 Date of lender's acquisition or knowledge of abandonment

2 Amount of debt outstanding $

BORROWER'S name (first, middle, last)

3 Amount of debt satisfied $

4 Fair market value of property at acquisition or abandonment $

Street address

5 Is borrower personally liable for repayment of the debt? ☐ Yes ☐ No

City, state, and ZIP code

6 Description of property

Account number (optional)

Copy B For Borrower

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.

Form **1099-A**

Department of the Treasury - Internal Revenue Service

☐ VOID ☐ CORRECTED

LENDER'S name, street address, city, state, and ZIP code

OMB No. 1545-0877

1988

Information Return for

Acquisition or Abandonment of Secured Property

LENDER'S Federal identification number

BORROWER'S identification number

1 Date of lender's acquisition or knowledge of abandonment

2 Amount of debt outstanding $

BORROWER'S name (first, middle, last)

3 Amount of debt satisfied $

4 Fair market value of property at acquisition or abandonment $

Street address

5 Is borrower personally liable for repayment of the debt? ☐ Yes ☐ No

City, state, and ZIP code

6 Description of property

Account number (optional)

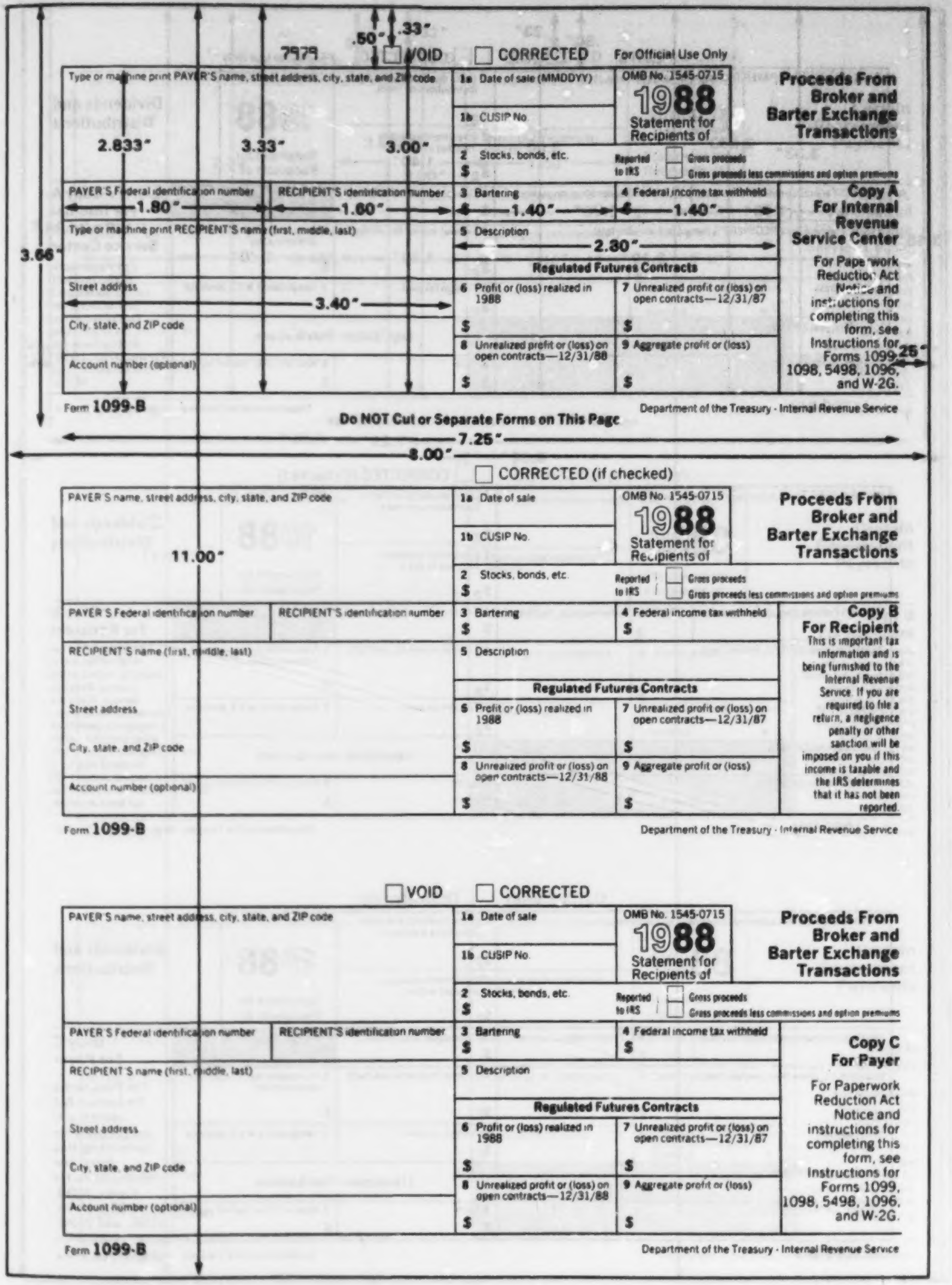
Copy C For Lender

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-A**

Department of the Treasury - Internal Revenue Service

Exhibit D



7979 ☐ VOID ☐ CORRECTED For Official Use Only

Type or machine print PAYER'S name, street address, city, state, and ZIP code

1a Date of sale (MMDDYY)

1b CUSIP No.

OMB No. 1545-0715
1988
Statement for Recipients of

Proceeds From Broker and Barter Exchange Transactions

2 Stocks, bonds, etc. $
Reported to IRS ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums

PAYER'S Federal identification number

RECIPIENT'S identification number

3 Bartering $

4 Federal income tax withheld $

Copy A For Internal Revenue Service Center

Type or machine print RECIPIENT'S name (first, middle, last)

5 Description

Regulated Futures Contracts

Street address

6 Profit or (loss) realized in 1988 $

7 Unrealized profit or (loss) on open contracts—12/31/87 $

City, state, and ZIP code

8 Unrealized profit or (loss) on open contracts—12/31/88 $

9 Aggregate profit or (loss) $

Account number (optional)

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-B** Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code

1a Date of sale

1b CUSIP No.

OMB No. 1545-0715
1988
Statement for Recipients of

Proceeds From Broker and Barter Exchange Transactions

2 Stocks, bonds, etc. $
Reported to IRS ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums

PAYER'S Federal identification number

RECIPIENT'S identification number

3 Bartering $

4 Federal income tax withheld $

Copy B For Recipient

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this income is taxable and the IRS determines that it has not been reported.

RECIPIENT'S name (first, middle, last)

5 Description

Regulated Futures Contracts

Street address

6 Profit or (loss) realized in 1988 $

7 Unrealized profit or (loss) on open contracts—12/31/87 $

City, state, and ZIP code

8 Unrealized profit or (loss) on open contracts—12/31/88 $

9 Aggregate profit or (loss) $

Account number (optional)

Form **1099-B** Department of the Treasury - Internal Revenue Service

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code

1a Date of sale

1b CUSIP No.

OMB No. 1545-0715
1988
Statement for Recipients of

Proceeds From Broker and Barter Exchange Transactions

2 Stocks, bonds, etc. $
Reported to IRS ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums

PAYER'S Federal identification number

RECIPIENT'S identification number

3 Bartering $

4 Federal income tax withheld $

Copy C For Payer

RECIPIENT'S name (first, middle, last)

5 Description

Regulated Futures Contracts

Street address

6 Profit or (loss) realized in 1988 $

7 Unrealized profit or (loss) on open contracts—12/31/87 $

City, state, and ZIP code

8 Unrealized profit or (loss) on open contracts—12/31/88 $

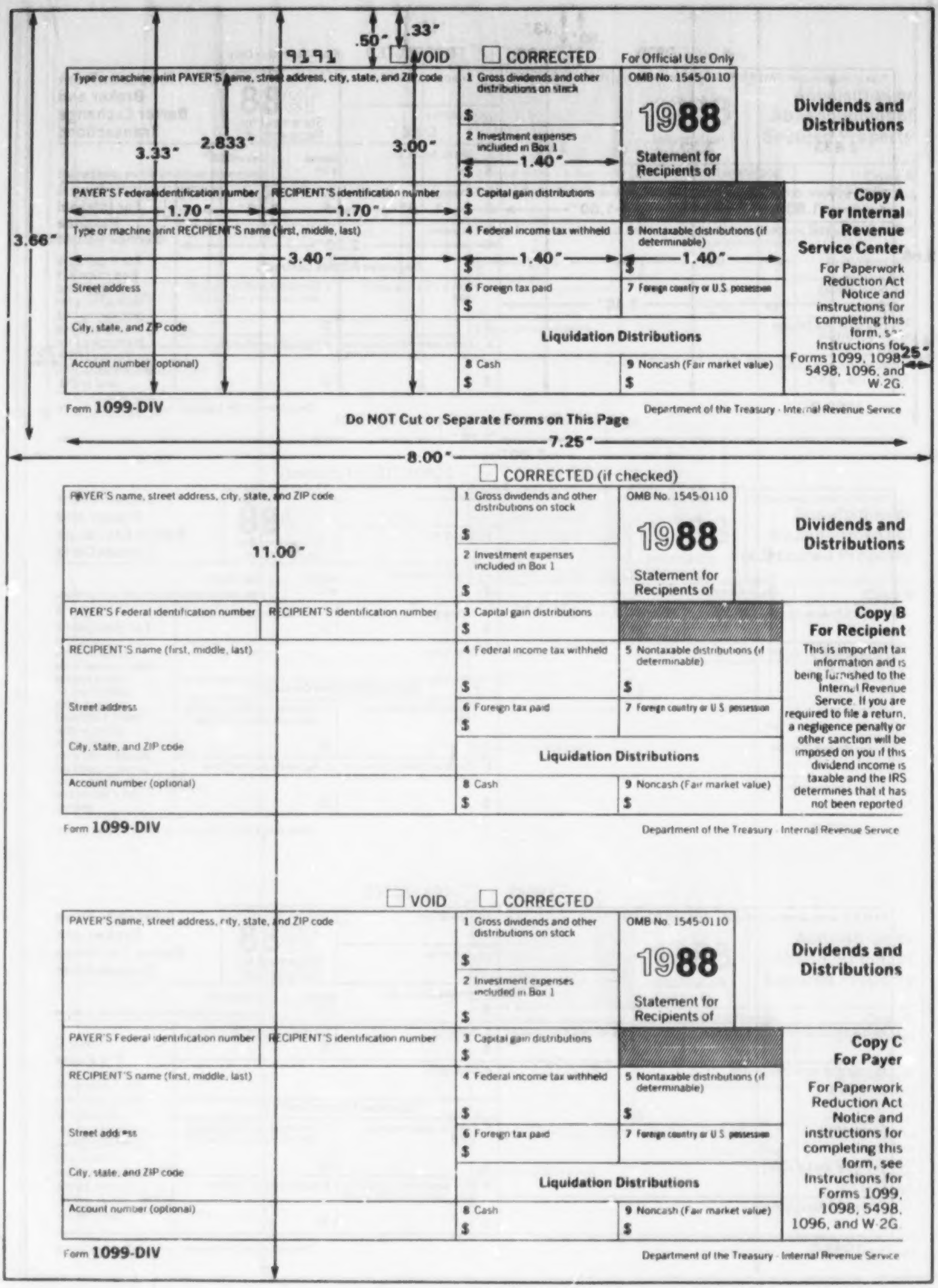
9 Aggregate profit or (loss) $

Account number (optional)

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-B** Department of the Treasury - Internal Revenue Service

Exhibit E



9191 ☐ VOID ☐ CORRECTED For Official Use Only

Type or machine print PAYER'S name, street address, city, state, and ZIP code		1 Gross dividends and other distributions on stock $	OMB No. 1545-0110 **1988** Statement for Recipients of	**Dividends and Distributions**
		2 Investment expenses included in Box 1 $		
PAYER'S Federal identification number	RECIPIENT'S identification number	3 Capital gain distributions $	▨	**Copy A** **For Internal Revenue Service Center**
Type or machine print RECIPIENT'S name (first, middle, last)		4 Federal income tax withheld $	5 Nontaxable distributions (if determinable) $	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.
Street address		6 Foreign tax paid $	7 Foreign country or U.S. possession	
City, state, and ZIP code		**Liquidation Distributions**		
Account number (optional)		8 Cash $	9 Noncash (Fair market value) $	

Form **1099-DIV** Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code		1 Gross dividends and other distributions on stock $	OMB No. 1545-0110 **1988** Statement for Recipients of	**Dividends and Distributions**
		2 Investment expenses included in Box 1 $		
PAYER'S Federal identification number	RECIPIENT'S identification number	3 Capital gain distributions $	▨	**Copy B** **For Recipient**
RECIPIENT'S name (first, middle, last)		4 Federal income tax withheld $	5 Nontaxable distributions (if determinable) $	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this dividend income is taxable and the IRS determines that it has not been reported
Street address		6 Foreign tax paid $	7 Foreign country or U.S. possession	
City, state, and ZIP code		**Liquidation Distributions**		
Account number (optional)		8 Cash $	9 Noncash (Fair market value) $	

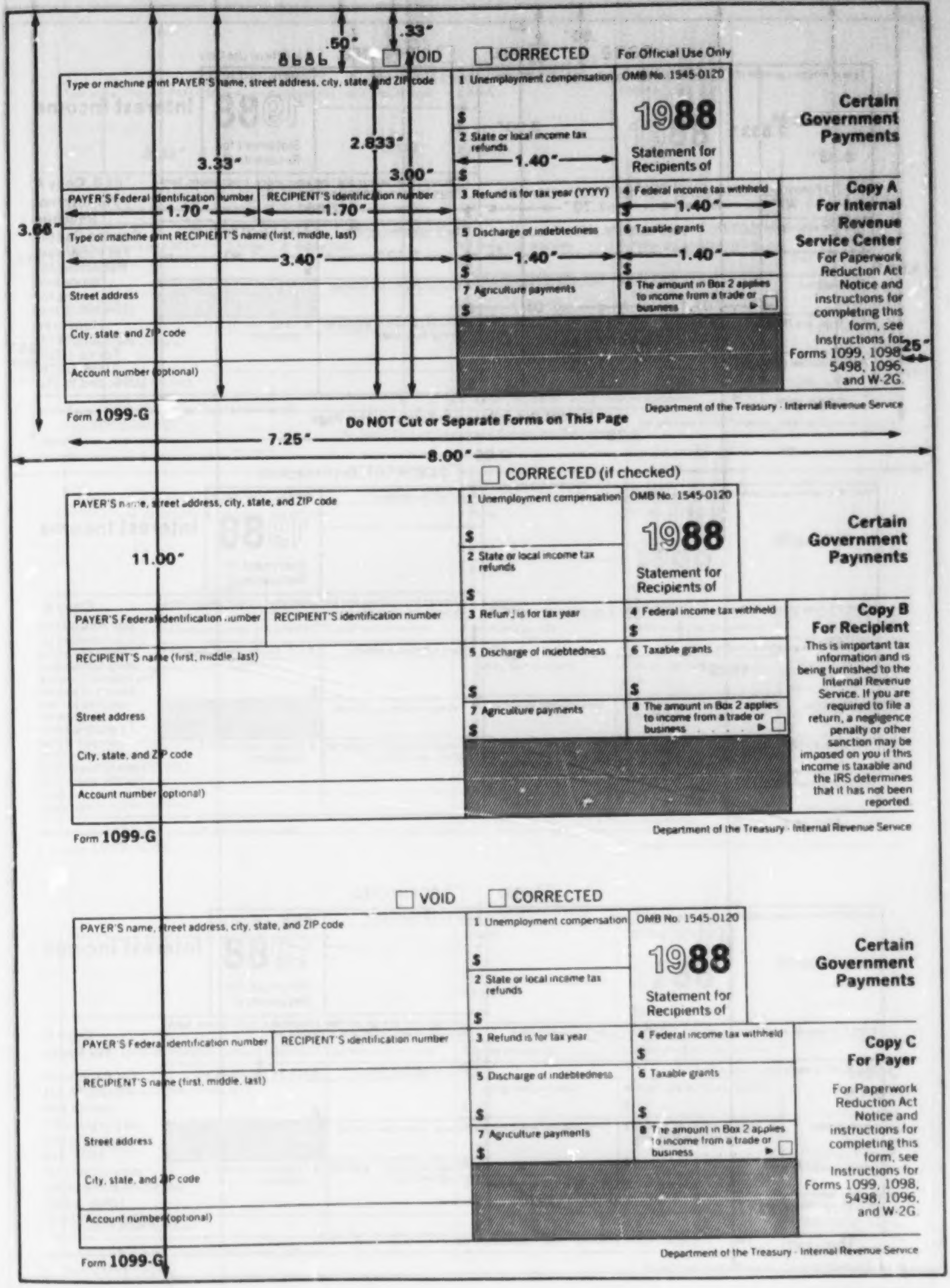
Form **1099-DIV** Department of the Treasury - Internal Revenue Service

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code		1 Gross dividends and other distributions on stock $	OMB No. 1545-0110 **1988** Statement for Recipients of	**Dividends and Distributions**
		2 Investment expenses included in Box 1 $		
PAYER'S Federal identification number	RECIPIENT'S identification number	3 Capital gain distributions $	▨	**Copy C** **For Payer**
RECIPIENT'S name (first, middle, last)		4 Federal income tax withheld $	5 Nontaxable distributions (if determinable) $	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.
Street address		6 Foreign tax paid $	7 Foreign country or U.S. possession	
City, state, and ZIP code		**Liquidation Distributions**		
Account number (optional)		8 Cash $	9 Noncash (Fair market value) $	

Form **1099-DIV** Department of the Treasury - Internal Revenue Service

Exhibit F



9898 ☐ VOID ☐ CORRECTED For Official Use Only

Type or machine print PAYER'S name, street address, city, state, and ZIP code

1 Unemployment compensation $

2 State or local income tax refunds $

OMB No. 1545-0120

1988

Statement for Recipients of

Certain Government Payments

PAYER'S Federal identification number

RECIPIENT'S identification number

3 Refund is for tax year (YYYY)

4 Federal income tax withheld $

Type or machine print RECIPIENT'S name (first, middle, last)

5 Discharge of indebtedness $

6 Taxable grants $

Street address

7 Agriculture payments $

8 The amount in Box 2 applies to income from a trade or business ▶ ☐

City, state and ZIP code

Account number (optional)

Copy A For Internal Revenue Service Center

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-G**

Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code

1 Unemployment compensation $

2 State or local income tax refunds $

OMB No. 1545-0120

1988

Statement for Recipients of

Certain Government Payments

PAYER'S Federal identification number

RECIPIENT'S identification number

3 Refund is for tax year

4 Federal income tax withheld $

RECIPIENT'S name (first, middle, last)

5 Discharge of indebtedness $

6 Taxable grants $

Street address

7 Agriculture payments $

8 The amount in Box 2 applies to income from a trade or business ▶ ☐

City, state, and ZIP code

Account number (optional)

Copy B For Recipient

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form **1099-G**

Department of the Treasury - Internal Revenue Service

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code

1 Unemployment compensation $

2 State or local income tax refunds $

OMB No. 1545-0120

1988

Statement for Recipients of

Certain Government Payments

PAYER'S Federal identification number

RECIPIENT'S identification number

3 Refund is for tax year

4 Federal income tax withheld $

RECIPIENT'S name (first, middle, last)

5 Discharge of indebtedness $

6 Taxable grants $

Street address

7 Agriculture payments $

8 The amount in Box 2 applies to income from a trade or business ▶ ☐

City, state, and ZIP code

Account number (optional)

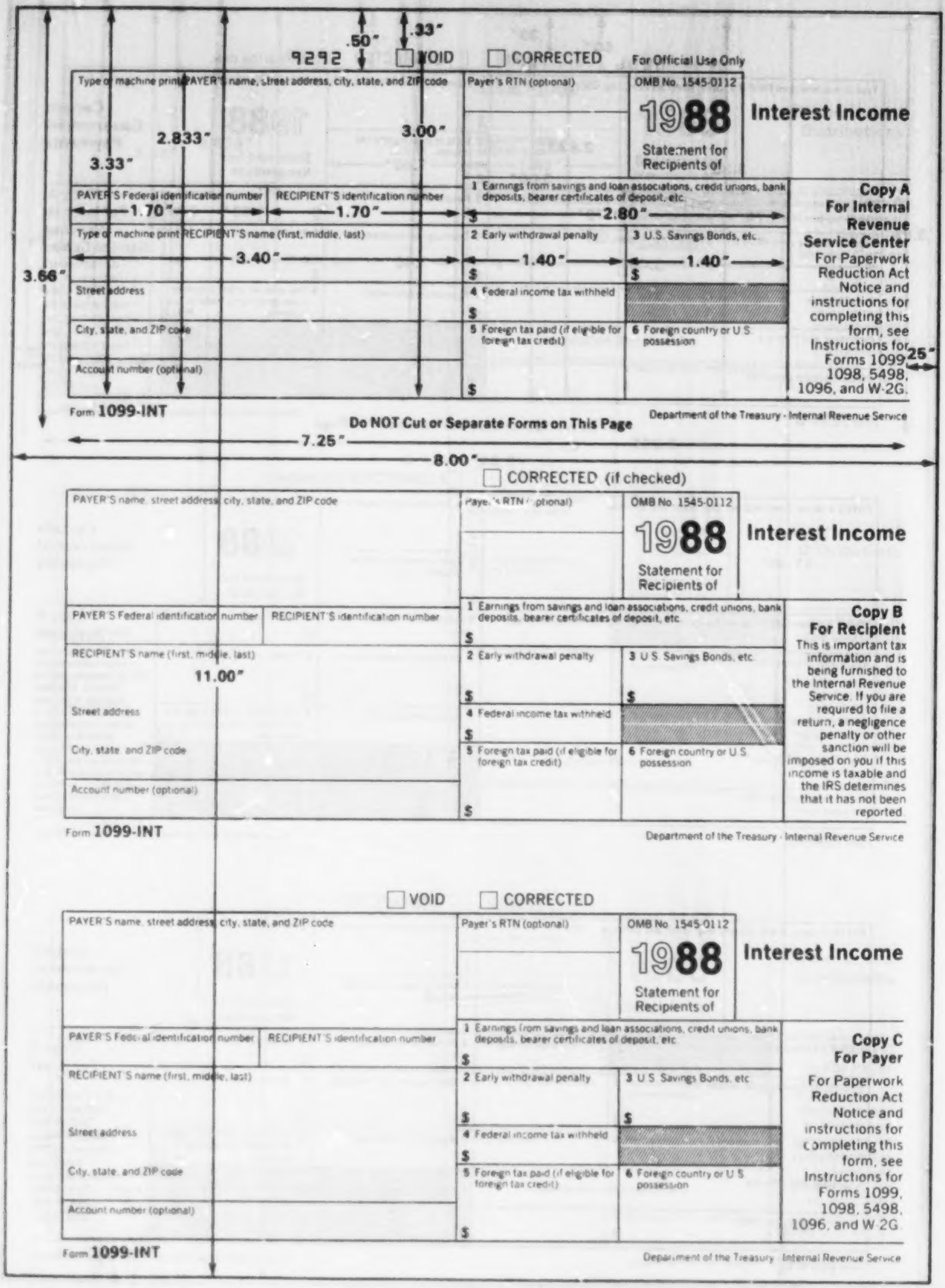
Copy C For Payer

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-G**

Department of the Treasury - Internal Revenue Service

Exhibit G



9292 ☐ VOID ☐ CORRECTED For Official Use Only

Type or machine print PAYER'S name, street address, city, state, and ZIP code	Payer's RTN (optional)	OMB No. 1545-0112 1988 Statement for Recipients of **Interest Income**
PAYER'S Federal identification number / RECIPIENT'S identification number	1 Earnings from savings and loan associations, credit unions, bank deposits, bearer certificates of deposit, etc. $	
Type or machine print RECIPIENT'S name (first, middle, last)	2 Early withdrawal penalty $	3 U.S. Savings Bonds, etc. $
Street address	4 Federal income tax withheld $	▨
City, state, and ZIP code	5 Foreign tax paid (if eligible for foreign tax credit) $	6 Foreign country or U.S. possession
Account number (optional)		

Copy A
For Internal Revenue Service Center
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-INT**

Do NOT Cut or Separate Forms on This Page

Department of the Treasury - Internal Revenue Service

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code	Payer's RTN (optional)	OMB No. 1545-0112 1988 Statement for Recipients of **Interest Income**
PAYER'S Federal identification number / RECIPIENT'S identification number	1 Earnings from savings and loan associations, credit unions, bank deposits, bearer certificates of deposit, etc. $	
RECIPIENT'S name (first, middle, last)	2 Early withdrawal penalty $	3 U.S. Savings Bonds, etc. $
Street address	4 Federal income tax withheld $	▨
City, state, and ZIP code	5 Foreign tax paid (if eligible for foreign tax credit) $	6 Foreign country or U.S. possession
Account number (optional)		

Copy B
For Recipient
This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form **1099-INT**

Department of the Treasury - Internal Revenue Service

☐ VOID ☐ CORRECTED

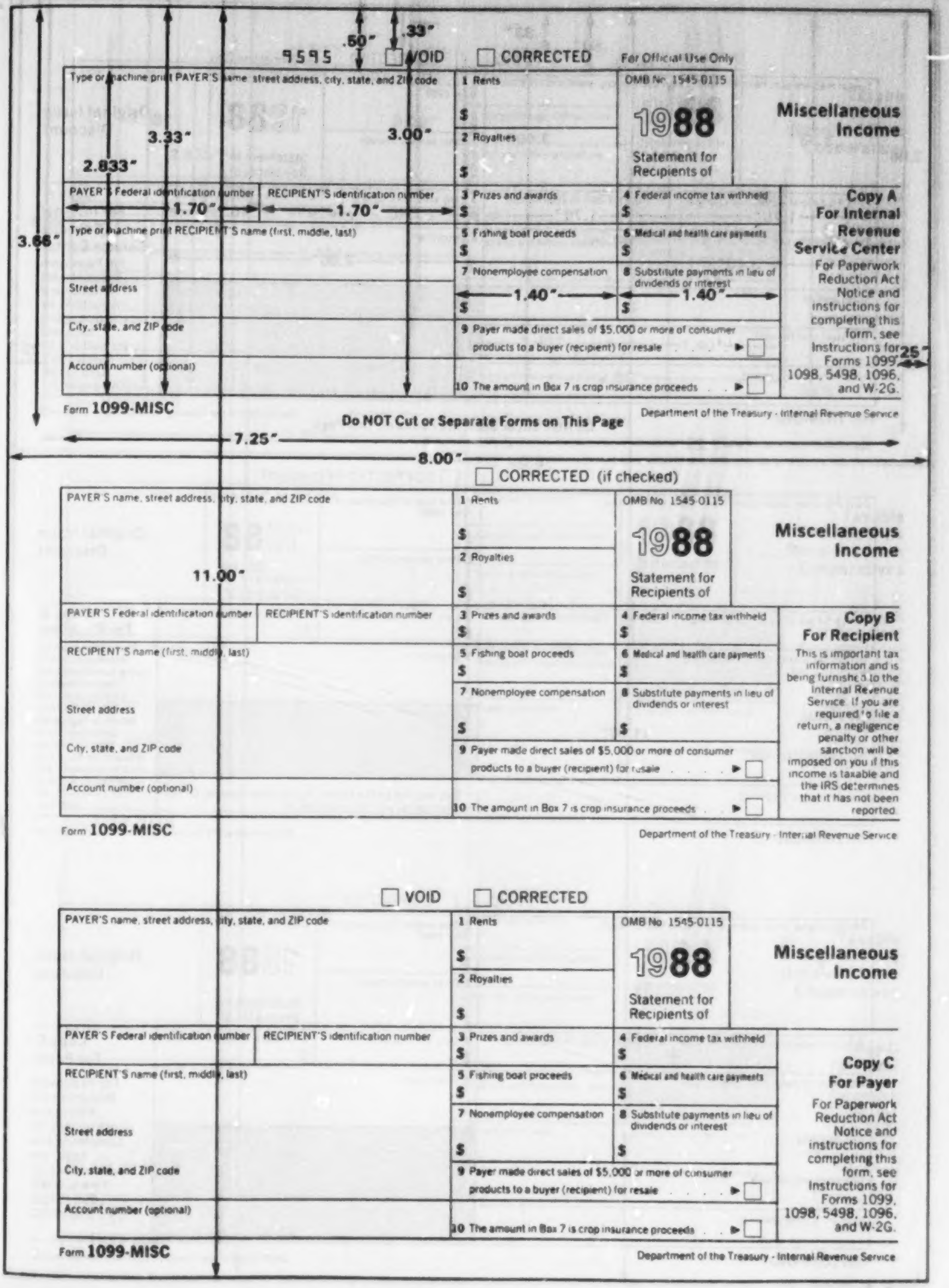
PAYER'S name, street address, city, state, and ZIP code	Payer's RTN (optional)	OMB No. 1545-0112 1988 Statement for Recipients of **Interest Income**
PAYER'S Federal identification number / RECIPIENT'S identification number	1 Earnings from savings and loan associations, credit unions, bank deposits, bearer certificates of deposit, etc. $	
RECIPIENT'S name (first, middle, last)	2 Early withdrawal penalty $	3 U.S. Savings Bonds, etc. $
Street address	4 Federal income tax withheld $	▨
City, state, and ZIP code	5 Foreign tax paid (if eligible for foreign tax credit) $	6 Foreign country or U.S. possession
Account number (optional)		

Copy C
For Payer
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-INT**

Department of the Treasury - Internal Revenue Service

Exhibit H



9595 ☐ VOID ☐ CORRECTED For Official Use Only

Type or machine print PAYER'S name, street address, city, state, and ZIP code

1 Rents $

2 Royalties $

OMB No. 1545-0115

1988

Statement for Recipients of

Miscellaneous Income

PAYER'S Federal identification number

RECIPIENT'S identification number

3 Prizes and awards $

4 Federal income tax withheld $

Type or machine print RECIPIENT'S name (first, middle, last)

5 Fishing boat proceeds $

6 Medical and health care payments $

Street address

7 Nonemployee compensation $

8 Substitute payments in lieu of dividends or interest $

City, state, and ZIP code

9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ▶ ☐

Account number (optional)

10 The amount in Box 7 is crop insurance proceeds . . ▶ ☐

Copy A For Internal Revenue Service Center

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-MISC**

Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code

1 Rents $

2 Royalties $

OMB No. 1545-0115

1988

Statement for Recipients of

Miscellaneous Income

PAYER'S Federal identification number

RECIPIENT'S identification number

3 Prizes and awards $

4 Federal income tax withheld $

RECIPIENT'S name (first, middle, last)

5 Fishing boat proceeds $

6 Medical and health care payments $

Street address

7 Nonemployee compensation $

8 Substitute payments in lieu of dividends or interest $

City, state, and ZIP code

9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale . . . . ▶ ☐

Account number (optional)

10 The amount in Box 7 is crop insurance proceeds . . ▶ ☐

Copy B For Recipient

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form **1099-MISC**

Department of the Treasury - Internal Revenue Service

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code

1 Rents $

2 Royalties $

OMB No. 1545-0115

1988

Statement for Recipients of

Miscellaneous Income

PAYER'S Federal identification number

RECIPIENT'S identification number

3 Prizes and awards $

4 Federal income tax withheld $

RECIPIENT'S name (first, middle, last)

5 Fishing boat proceeds $

6 Medical and health care payments $

Street address

7 Nonemployee compensation $

8 Substitute payments in lieu of dividends or interest $

City, state, and ZIP code

9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale . . . . ▶ ☐

Account number (optional)

10 The amount in Box 7 is crop insurance proceeds . . ▶ ☐

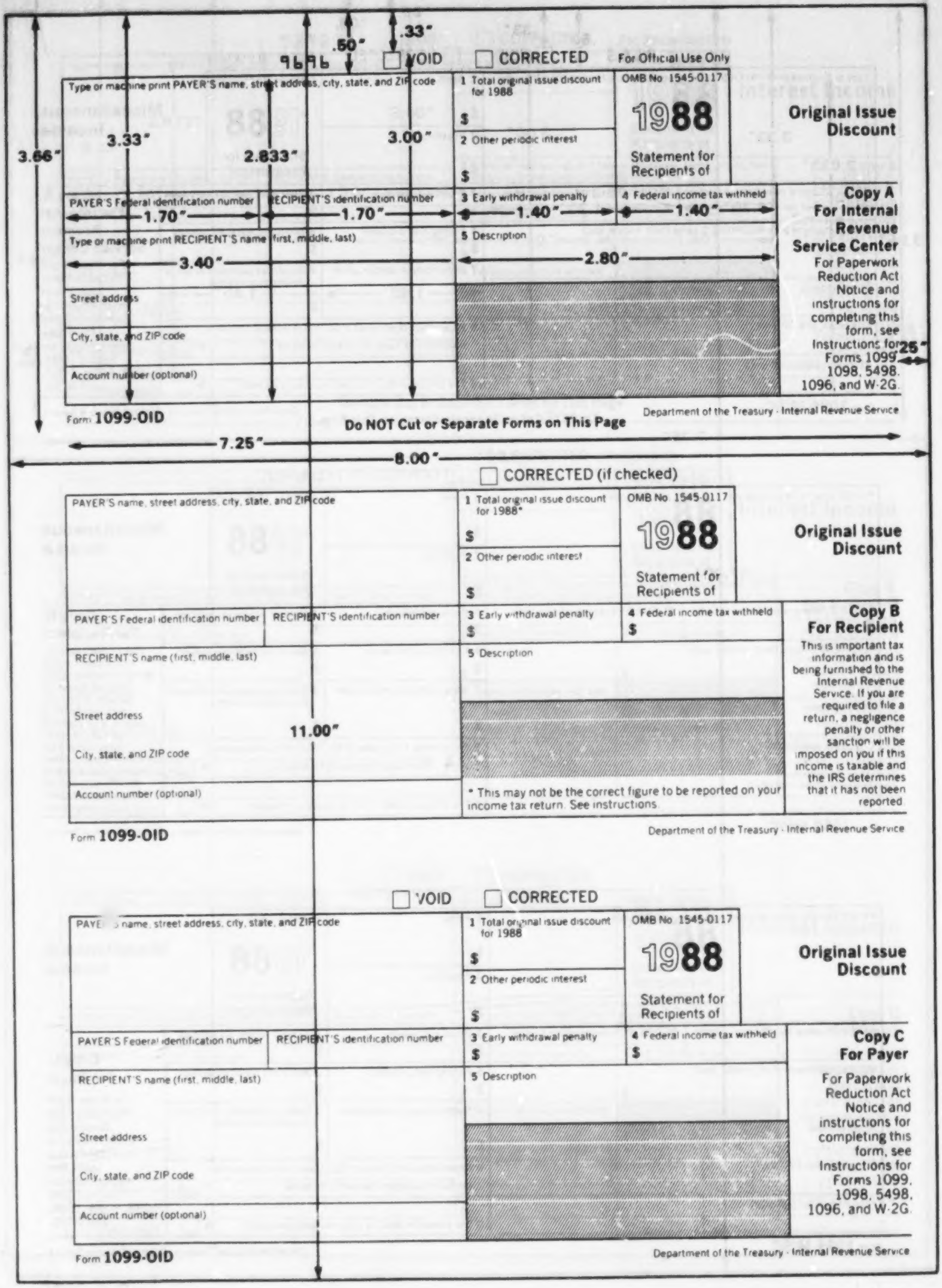
Copy C For Payer

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-MISC**

Department of the Treasury - Internal Revenue Service

Exhibit I



.33"
.50"
9696
3.66"
3.33"
2.833"
3.00"
1.70"
1.70"
1.40"
1.40"
3.40"
2.80"
.25"
7.25"
8.00"
11.00"

☐ VOID ☐ CORRECTED For Official Use Only

Type or machine print PAYER'S name, street address, city, state, and ZIP code	1 Total original issue discount for 1988 $ 2 Other periodic interest $	OMB No. 1545-0117 1988 Statement for Recipients of	**Original Issue Discount**
PAYER'S Federal identification number	RECIPIENT'S identification number	3 Early withdrawal penalty	4 Federal income tax withheld
Type or machine print RECIPIENT'S name (first, middle, last) Street address City, state, and ZIP code Account number (optional)	5 Description		**Copy A For Internal Revenue Service Center** For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-OID** Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code	1 Total original issue discount for 1988* $ 2 Other periodic interest $	OMB No. 1545-0117 1988 Statement for Recipients of	**Original Issue Discount**
PAYER'S Federal identification number	RECIPIENT'S identification number	3 Early withdrawal penalty $	4 Federal income tax withheld $
RECIPIENT'S name (first, middle, last) Street address City, state, and ZIP code Account number (optional)	5 Description * This may not be the correct figure to be reported on your income tax return. See instructions.		**Copy B For Recipient** This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this income is taxable and the IRS determines that it has not been reported.

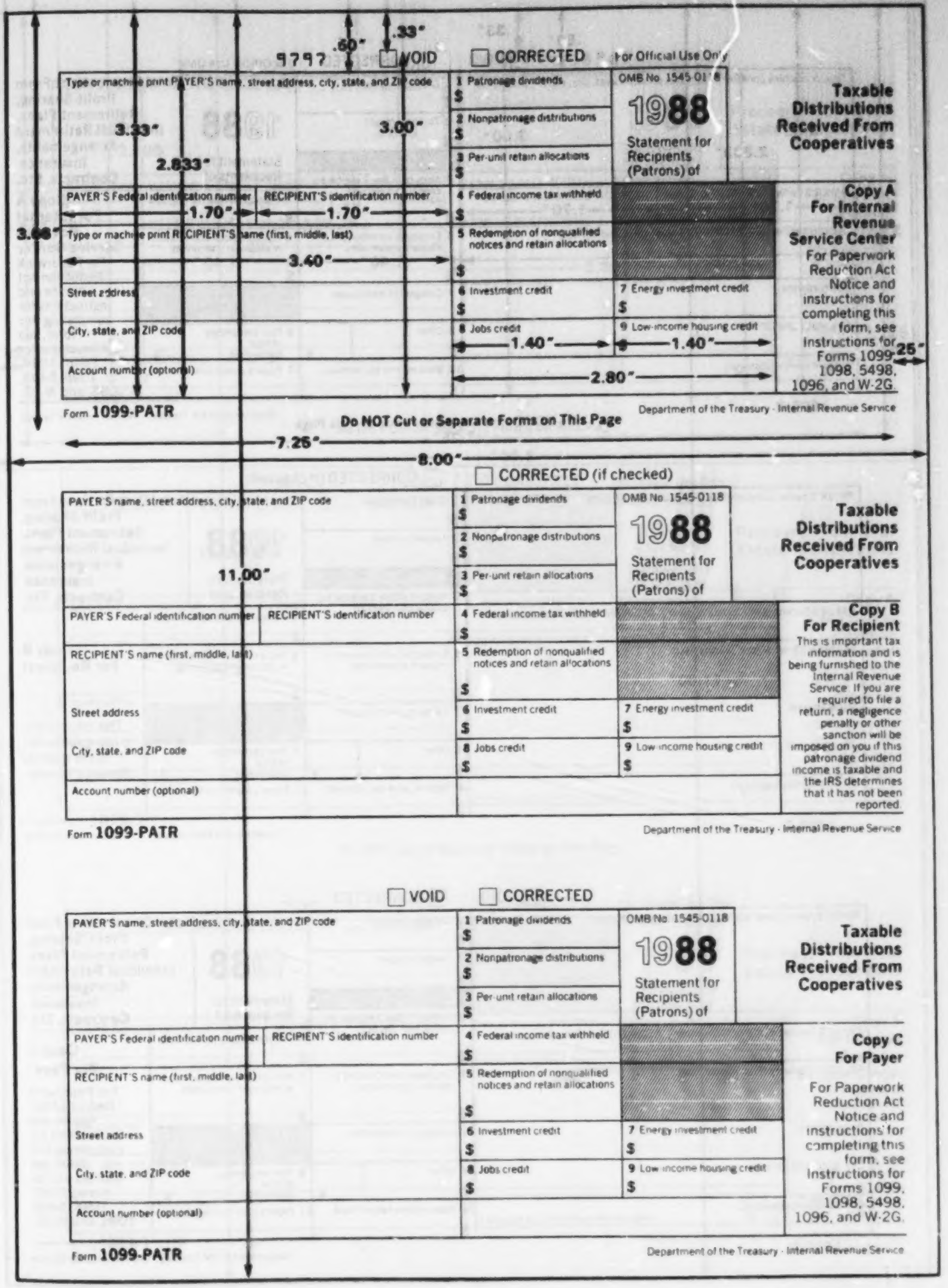
Form **1099-OID** Department of the Treasury - Internal Revenue Service

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Total original issue discount for 1988 $ 2 Other periodic interest $	OMB No. 1545-0117 1988 Statement for Recipients of	**Original Issue Discount**
PAYER'S Federal identification number	RECIPIENT'S identification number	3 Early withdrawal penalty $	4 Federal income tax withheld $
RECIPIENT'S name (first, middle, last) Street address City, state, and ZIP code Account number (optional)	5 Description		**Copy C For Payer** For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-OID** Department of the Treasury - Internal Revenue Service

Exhibit J


.60"
.33"
3.33"
2.833"
3.00"
1.70"
1.70"
3.66"
3.40"
1.40"
1.40"
.25"
2.80"
7.25"
8.00"
11.00"

9797 ☐ VOID ☐ CORRECTED For Official Use Only

Type or machine print PAYER'S name, street address, city, state, and ZIP code	1 Patronage dividends $	OMB No. 1545-0118 **1988** Statement for Recipients (Patrons) of	**Taxable Distributions Received From Cooperatives**
	2 Nonpatronage distributions $		
	3 Per-unit retain allocations $		
PAYER'S Federal identification number / RECIPIENT'S identification number	4 Federal income tax withheld $		**Copy A For Internal Revenue Service Center** For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.
Type or machine print RECIPIENT'S name (first, middle, last)	5 Redemption of nonqualified notices and retain allocations $		
Street address	6 Investment credit $	7 Energy investment credit $	
City, state, and ZIP code	8 Jobs credit $	9 Low-income housing credit $	
Account number (optional)			

Form **1099-PATR** Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code	1 Patronage dividends $	OMB No. 1545-0118 **1988** Statement for Recipients (Patrons) of	**Taxable Distributions Received From Cooperatives**
	2 Nonpatronage distributions $		
	3 Per-unit retain allocations $		
PAYER'S Federal identification number / RECIPIENT'S identification number	4 Federal income tax withheld $		**Copy B For Recipient** This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this patronage dividend income is taxable and the IRS determines that it has not been reported.
RECIPIENT'S name (first, middle, last)	5 Redemption of nonqualified notices and retain allocations $		
Street address	6 Investment credit $	7 Energy investment credit $	
City, state, and ZIP code	8 Jobs credit $	9 Low-income housing credit $	
Account number (optional)			

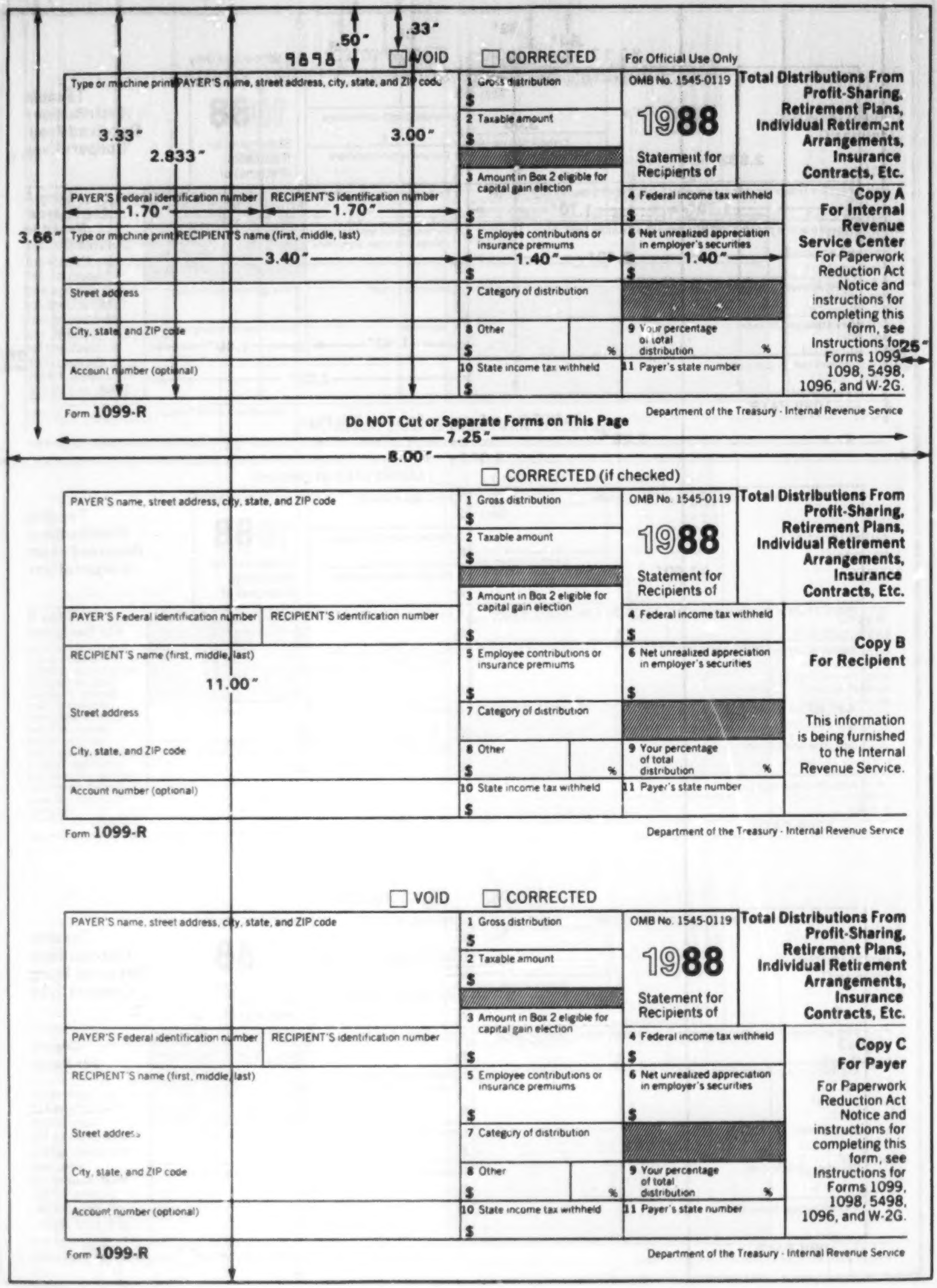
Form **1099-PATR** Department of the Treasury - Internal Revenue Service

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Patronage dividends $	OMB No. 1545-0118 **1988** Statement for Recipients (Patrons) of	**Taxable Distributions Received From Cooperatives**
	2 Nonpatronage distributions $		
	3 Per-unit retain allocations $		
PAYER'S Federal identification number / RECIPIENT'S identification number	4 Federal income tax withheld $		**Copy C For Payer** For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.
RECIPIENT'S name (first, middle, last)	5 Redemption of nonqualified notices and retain allocations $		
Street address	6 Investment credit $	7 Energy investment credit $	
City, state, and ZIP code	8 Jobs credit $	9 Low-income housing credit $	
Account number (optional)			

Form **1099-PATR** Department of the Treasury - Internal Revenue Service

Exhibit K



9898 ☐ VOID ☐ CORRECTED For Official Use Only

Type or machine print PAYER'S name, street address, city, state, and ZIP code

1 Gross distribution
$

2 Taxable amount
$

3 Amount in Box 2 eligible for capital gain election
$

OMB No. 1545-0119

1988

Statement for Recipients of

Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.

PAYER'S Federal identification number

RECIPIENT'S identification number

4 Federal income tax withheld
$

Type or machine print RECIPIENT'S name (first, middle, last)

5 Employee contributions or insurance premiums
$

6 Net unrealized appreciation in employer's securities
$

Street address

7 Category of distribution

City, state, and ZIP code

8 Other
$ %

9 Your percentage of total distribution %

Account number (optional)

10 State income tax withheld
$

11 Payer's state number

Copy A For Internal Revenue Service Center

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-R**

Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code

1 Gross distribution
$

2 Taxable amount
$

3 Amount in Box 2 eligible for capital gain election
$

OMB No. 1545-0119

1988

Statement for Recipients of

Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.

PAYER'S Federal identification number

RECIPIENT'S identification number

4 Federal income tax withheld
$

RECIPIENT'S name (first, middle, last)

5 Employee contributions or insurance premiums
$

6 Net unrealized appreciation in employer's securities
$

Street address

7 Category of distribution

City, state, and ZIP code

8 Other
$ %

9 Your percentage of total distribution %

Account number (optional)

10 State income tax withheld
$

11 Payer's state number

Copy B For Recipient

This information is being furnished to the Internal Revenue Service.

Form **1099-R**

Department of the Treasury - Internal Revenue Service

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code

1 Gross distribution
$

2 Taxable amount
$

3 Amount in Box 2 eligible for capital gain election
$

OMB No. 1545-0119

1988

Statement for Recipients of

Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.

PAYER'S Federal identification number

RECIPIENT'S identification number

4 Federal income tax withheld
$

RECIPIENT'S name (first, middle, last)

5 Employee contributions or insurance premiums
$

6 Net unrealized appreciation in employer's securities
$

Street address

7 Category of distribution

City, state, and ZIP code

8 Other
$ %

9 Your percentage of total distribution %

Account number (optional)

10 State income tax withheld
$

11 Payer's state number

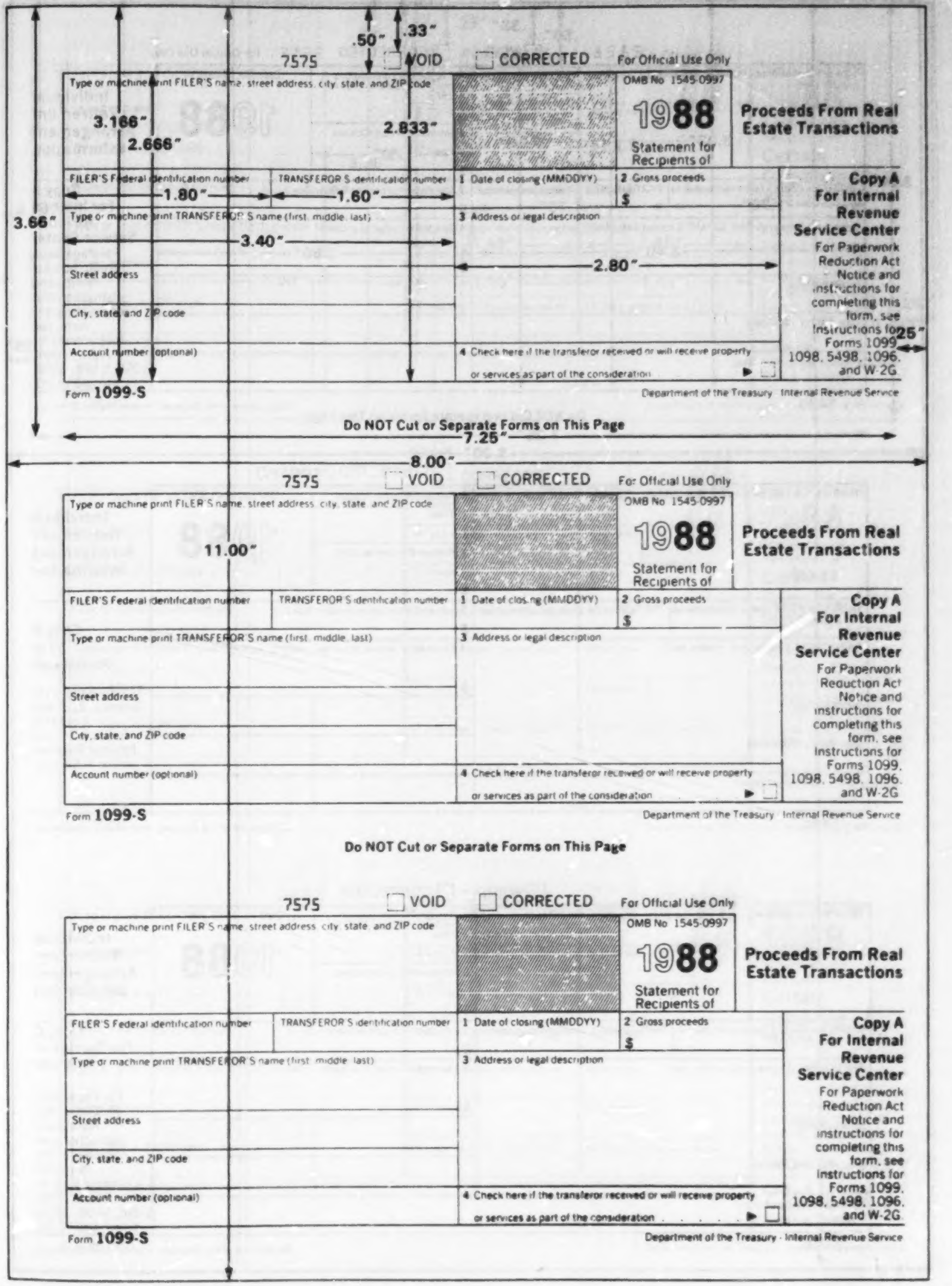
Copy C For Payer

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-R**

Department of the Treasury - Internal Revenue Service

Exhibit L



7575 ☐ VOID ☐ CORRECTED For Official Use Only

Type or machine print FILER'S name, street address, city, state, and ZIP code

OMB No. 1545-0997

1988

Statement for Recipients of

Proceeds From Real Estate Transactions

FILER'S Federal identification number

TRANSFEROR'S identification number

1 Date of closing (MMDDYY)

2 Gross proceeds

$

Type or machine print TRANSFEROR'S name (first, middle, last)

3 Address or legal description

Street address

City, state, and ZIP code

Account number (optional)

4 Check here if the transferor received or will receive property or services as part of the consideration ▶ ☐

Copy A For Internal Revenue Service Center

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-S**

Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

7575 ☐ VOID ☐ CORRECTED For Official Use Only

Type or machine print FILER'S name, street address, city, state, and ZIP code

OMB No. 1545-0997

1988

Statement for Recipients of

Proceeds From Real Estate Transactions

FILER'S Federal identification number

TRANSFEROR'S identification number

1 Date of closing (MMDDYY)

2 Gross proceeds

$

Type or machine print TRANSFEROR'S name (first, middle, last)

3 Address or legal description

Street address

City, state, and ZIP code

Account number (optional)

4 Check here if the transferor received or will receive property or services as part of the consideration ▶ ☐

Copy A For Internal Revenue Service Center

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-S**

Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

7575 ☐ VOID ☐ CORRECTED For Official Use Only

Type or machine print FILER'S name, street address, city, state, and ZIP code

OMB No. 1545-0997

1988

Statement for Recipients of

Proceeds From Real Estate Transactions

FILER'S Federal identification number

TRANSFEROR'S identification number

1 Date of closing (MMDDYY)

2 Gross proceeds

$

Type or machine print TRANSFEROR'S name (first, middle, last)

3 Address or legal description

Street address

City, state, and ZIP code

Account number (optional)

4 Check here if the transferor received or will receive property or services as part of the consideration . . . . . ▶ ☐

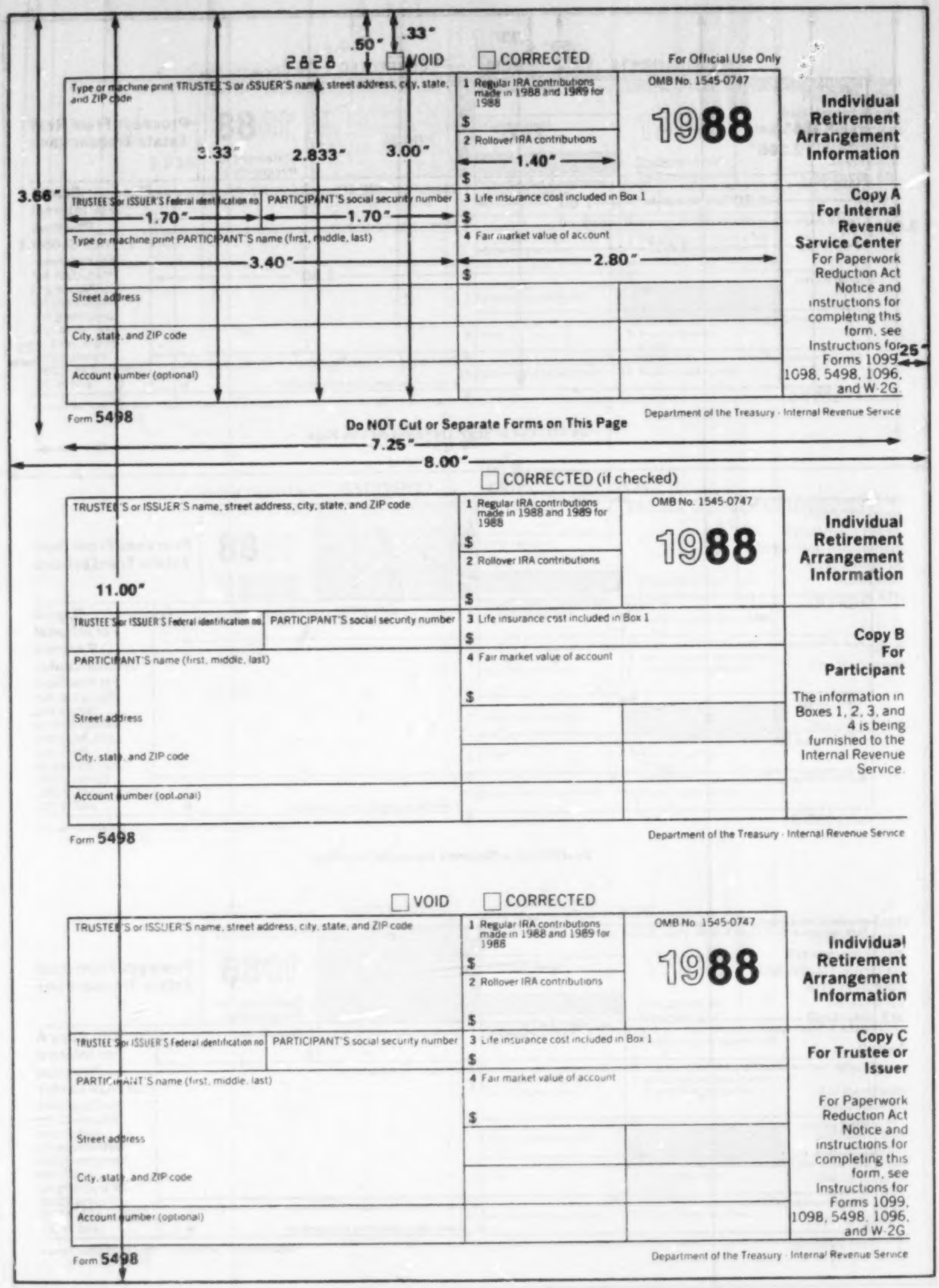
Copy A For Internal Revenue Service Center

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **1099-S**

Department of the Treasury - Internal Revenue Service

Exhibit M


.50"
.33"
3.33"
2.833"
3.00"
1.40"
3.66"
1.70"
1.70"
3.40"
2.80"
.25"
7.25"
8.00"
11.00"

2828 ☐ VOID ☐ CORRECTED For Official Use Only

Type or machine print TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code

1 Regular IRA contributions made in 1988 and 1989 for 1988
$

2 Rollover IRA contributions
$

OMB No. 1545-0747

1988

Individual Retirement Arrangement Information

TRUSTEE'S or ISSUER'S Federal identification no.

PARTICIPANT'S social security number

3 Life insurance cost included in Box 1
$

Type or machine print PARTICIPANT'S name (first, middle, last)

4 Fair market value of account
$

Street address

City, state, and ZIP code

Account number (optional)

Copy A For Internal Revenue Service Center

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **5498**

Department of the Treasury · Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

☐ CORRECTED (if checked)

TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code

1 Regular IRA contributions made in 1988 and 1989 for 1988
$

2 Rollover IRA contributions
$

OMB No. 1545-0747

1988

Individual Retirement Arrangement Information

TRUSTEE'S or ISSUER'S Federal identification no.

PARTICIPANT'S social security number

3 Life insurance cost included in Box 1
$

PARTICIPANT'S name (first, middle, last)

4 Fair market value of account
$

Street address

City, state, and ZIP code

Account number (optional)

Copy B For Participant

The information in Boxes 1, 2, 3, and 4 is being furnished to the Internal Revenue Service.

Form **5498**

Department of the Treasury · Internal Revenue Service

☐ VOID ☐ CORRECTED

TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code

1 Regular IRA contributions made in 1988 and 1989 for 1988
$

2 Rollover IRA contributions
$

OMB No. 1545-0747

1988

Individual Retirement Arrangement Information

TRUSTEE'S or ISSUER'S Federal identification no.

PARTICIPANT'S social security number

3 Life insurance cost included in Box 1
$

PARTICIPANT'S name (first, middle, last)

4 Fair market value of account
$

Street address

City, state, and ZIP code

Account number (optional)

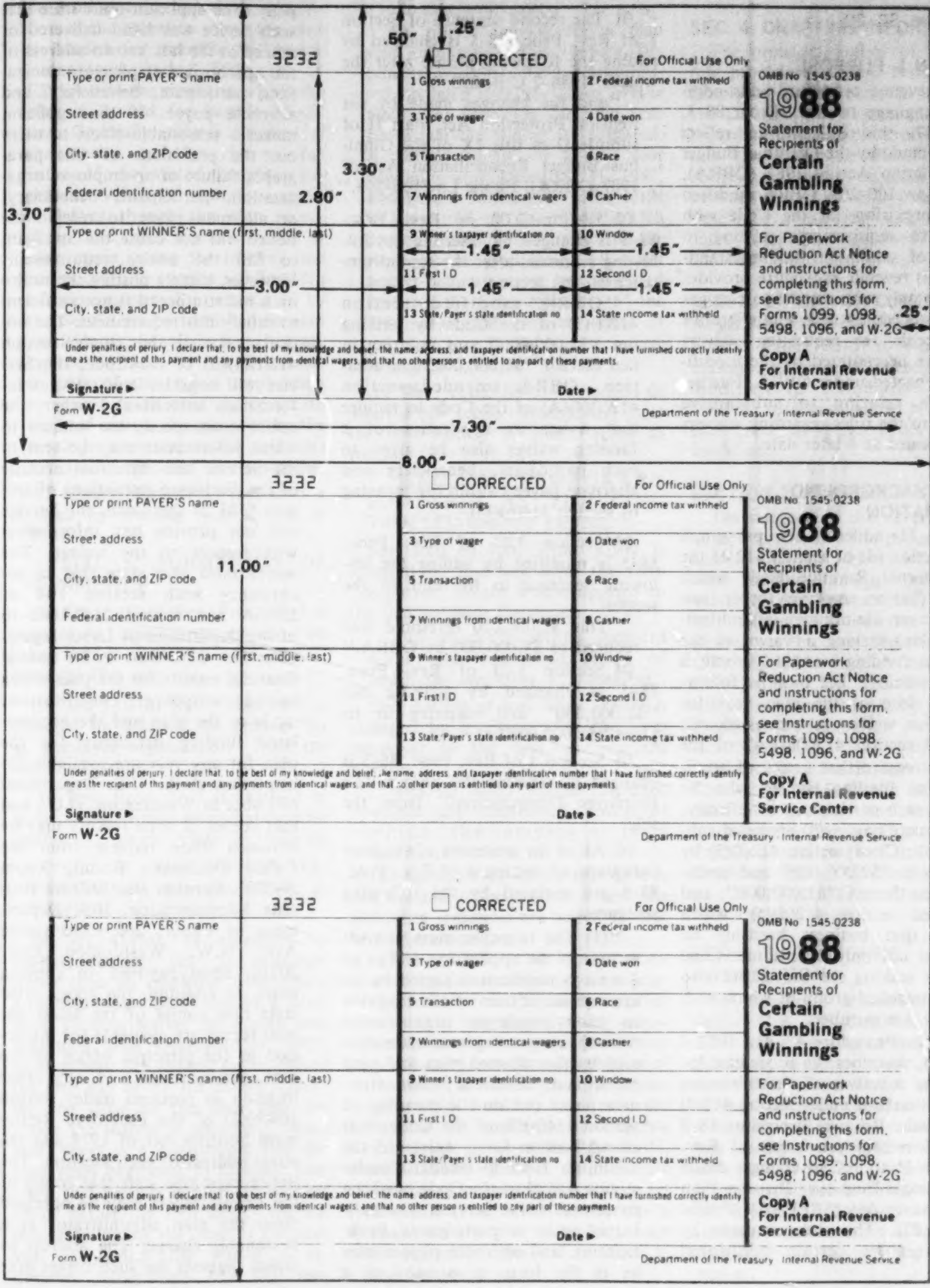
Copy C For Trustee or Issuer

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form **5498**

Department of the Treasury · Internal Revenue Service

Exhibit N



3232

☐ CORRECTED

For Official Use Only

Type or print PAYER'S name

Street address

City, state, and ZIP code

Federal identification number

Type or print WINNER'S name (first, middle, last)

Street address

City, state, and ZIP code

1 Gross winnings	2 Federal income tax withheld
3 Type of wager	4 Date won
5 Transaction	6 Race
7 Winnings from identical wagers	8 Cashier
9 Winner's taxpayer identification no	10 Window
11 First I D	12 Second I D
13 State/Payer's state identification no	14 State income tax withheld

OMB No 1545-0238

1988

Statement for Recipients of

Certain Gambling Winnings

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G

Copy A
For Internal Revenue Service Center

Under penalties of perjury, I declare that, to the best of my knowledge and belief, the name, address, and taxpayer identification number that I have furnished correctly identify me as the recipient of this payment and any payments from identical wagers, and that no other person is entitled to any part of these payments.

Signature ▶ **Date ▶**

Form **W-2G**

Department of the Treasury · Internal Revenue Service

3232

☐ CORRECTED

For Official Use Only

Type or print PAYER'S name

Street address

City, state, and ZIP code

Federal identification number

Type or print WINNER'S name (first, middle, last)

Street address

City, state, and ZIP code

1 Gross winnings | 2 Federal income tax withheld
3 Type of wager | 4 Date won
5 Transaction | 6 Race
7 Winnings from identical wagers | 8 Cashier
9 Winner's taxpayer identification no | 10 Window
11 First I D | 12 Second I D
13 State/Payer's state identification no | 14 State income tax withheld

OMB No 1545-0238

1988

Statement for Recipients of Certain Gambling Winnings

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G

Copy A For Internal Revenue Service Center

Under penalties of perjury, I declare that, to the best of my knowledge and belief, the name, address, and taxpayer identification number that I have furnished correctly identify me as the recipient of this payment and any payments from identical wagers, and that no other person is entitled to any part of these payments.

Signature ▶ Date ▶

Form W-2G

Department of the Treasury · Internal Revenue Service

3232

☐ CORRECTED

For Official Use Only

Type or print PAYER'S name

Street address

City, state, and ZIP code

Federal identification number

Type or print WINNER'S name (first, middle, last)

Street address

City, state, and ZIP code

1 Gross winnings | 2 Federal income tax withheld
3 Type of wager | 4 Date won
5 Transaction | 6 Race
7 Winnings from identical wagers | 8 Cashier
9 Winner's taxpayer identification no | 10 Window
11 First I D | 12 Second I D
13 State/Payer's state identification no | 14 State income tax withheld

OMB No 1545-0238

1988

Statement for Recipients of Certain Gambling Winnings

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G

Copy A For Internal Revenue Service Center

Under penalties of perjury, I declare that, to the best of my knowledge and belief, the name, address, and taxpayer identification number that I have furnished correctly identify me as the recipient of this payment and any payments from identical wagers, and that no other person is entitled to any part of these payments.

Signature ▶ Date ▶

Form W-2G

Department of the Treasury · Internal Revenue Service

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 88-29

SECTION 1. PURPOSE

This revenue procedure adds additional language to Rev. Proc. 88-5, page 587, this Bulletin, to reflect changes made by the Omnibus Budget Reconciliation Act of 1987 (OBRA), Public Law 100-203. OBRA modified certain provisions of the Code with respect to requirements relating to waivers of minimum funding standards. This revenue procedure provides guidance only with respect to changes in the procedures and administrative requirements for requesting waivers which are necessitated by the modifications enacted under OBRA. Further guidance relating to substantive changes to the rules regarding waivers will be issued at a later date.

SEC. 2. BACKGROUND INFORMATION

OBRA (1) added a new paragraph to subsection (d) of section 412 of the 1986 Internal Revenue Code which requires that an employer (other than an employer maintaining a multiemployer plan) seeking a waiver of the minimum funding standard submit a request within 2 1/2 months following the close of the plan year for which the waiver is requested; (2) amended section 412(f)(4)(A) of the Code to require that notice of application for funding waivers also be given to each participant, beneficiary, and alternate payee; (3) amended subparagraph (C) of section 412(f)(3) by striking out "$2,000,000" and inserting in lieu thereof "$1,000,000"; and (4) added section 412(d)(5), which requires that business hardship be evidenced not only by the individual employer seeking the waiver but also by the controlled group of which such employer is a member.

Revenue Procedure 83-41, 1983-1 C.B. 775, describes the procedure for requesting a waiver of the minimum funding standard under section 412(d) of the Code. Revenue Procedure 88-5 modified certain provisions of Rev. Proc. 83-41 to reflect changes made by the Single Employer Pension Plan Amendments Act (SEPPAA), Public Law 99-272. The changes made by OBRA require certain additional changes.

SEC. 3. CHANGES TO REV. PROC. 88-5

.01 The second sentence of Section 1 of Rev. Proc. 88-5 is changed by adding the following phrase after the words "1986-2 C.B. 298."

> "and the changes made by the Pension Protection Act, Part II of subtitle D of title IX of the Omnibus Budget Reconciliation Act of 1987 (OBRA), Public Law 100-203."

.02 Section 2.02 of Rev. Proc. 88-5 is changed by inserting the following sentences after the second sentence of that section.

> "OBRA modified section 412(f)(3) of the Code by striking out "$2,000,000" and inserting in lieu thereof "$1,000,000". In addition, OBRA amended section 412(f)(4)(A) of the Code to require that notice of application of a funding waiver also be given to each participant, beneficiary and alternate payee (within the meaning of section 414(p)(8))."

.03 Section 3.01 of Rev. Proc. 88-5 is modified by adding the following sentence to the end of the section.

> "This $2,000,000 threshold was reduced to $1,000,000 by OBRA."

.04 Section 3.03 of Rev. Proc. 88-5 is changed by striking out "$2,000,000" and inserting in its place "$1,000,000".

.05 Section 4 of Rev. Proc. 88-5 is changed by deleting the phrase "To Employee Organizations" from the title.

.06 All of the sentences of the inset paragraph of section 4 of Rev. Proc. 88-5 are replaced by the following sentences.

> "(3) The taxpayer must provide as part of the application a copy of a written notification signed by an appropriate officer of the taxpayer to each employee organization (union) representing employees covered by the affected plan and each participant, beneficiary, and alternate payee (within the meaning of section 414(p)(8) of the Code) that an application for a waiver of the minimum funding standard under section 412(d) of the Code has been submitted to the Service. The individual notice to participants, beneficiaries, and alternate payees may be in the form of a copy of a general notice which was signed by an appropriate officer of the company. The applicant must state that such notice was hand delivered or mailed to the last known address of the appropriate employee organization, participant, beneficiary, and alternate payee. If the applicant makes a reasonable effort to carry out the provisions of this paragraph, failure of an employee organization, participant, beneficiary, or alternate payee to receive the notice will not cause the applicant to fail the notice requirement. However, merely posting the notice on a bulletin board is not sufficient to satisfy this requirement. The notice must state that, under section 412(f)(4)(B) of the Code, the Service will consider any relevant information submitted. Further, the notice must specify the address to which information may be sent to the Service and state that because of the disclosure restrictions of section 6103 of the Code, the Service will not provide any information with respect to the waiver. The notice must also state that in accordance with section 104 of ERISA and section 2520.104b-10 of the Department of Labor regulations (29 CFR Part 2520) annual financial reports for the plan which include employer contributions made to the plan and the accumulated funding deficiency for the plan for any year are available for inspection at the U.S. Department of Labor in Washington, D.C., and that copies of such reports may be obtained upon request from the Public Disclosure Room, Room N-5507, Pension and Welfare Benefits Administration, U.S. Department of Labor, 200 Constitution Ave., N.W., Washington, D.C. 20210, upon payment of copying costs. In addition, the notice must state that copies of the latest annual report are available for inspection at the principal office of the plan administrator and any other location as required under section 104(b)(2) of the Employee Retirement Security Act of 1974 and the street address of such location. The notice must also state that copies of the annual report may be obtained from the plan administrator at a reasonable charge. The address to which requests for such copies may

be sent and the amount of the charge must be stated. In addition, the notice must include a description of the extent to which the plan is funded for benefits which are guaranteed under Title IV of ERISA and the extent to which the plan is funded for benefit liabilities. Generally, this is satisfied if the notice includes the present value of the vested benefits, the present value of benefits determined as though the plan terminated, and the fair market value of plan assets, using the interest rate for calculating current liability. No addition information is required by the Service to be furnished to plan participants, beneficiaries, alternate payees or employee organizations as part of the waiver application process. Additional information may, of course, be provided by the employer pursuant to the collective bargaining process or otherwise.

.07 Section 5 of Rev. Proc. 88-5 is changed by retitling such section as follows.

"SEC. 5. SUBMISSION OF COMMENTS"

.08 Sec. 5.02 of Rev. Proc. 88-5 is changed by deleting the phrase "on behalf of an employee organization" from the first sentence.

.09 Sec 5.03 of Rev. Proc. 88-5 is changed by deleting the phrase "by an employee organization" from the second sentence.

.10 Rev. Proc. 88-5 is changed to insert a new section immediately after section 5, which reads as follows.

"SEC. 6. TIME WHEN APPROPRIATE TO REQUEST A WAIVER

Section 414(d), as amended by OBRA, requires that an employer (other than an employer maintaining a multiemployer plan) seeking a minimum funding waiver for a plan year beginning after December 31, 1987, must submit the request on or before the 15th day of the 3rd month following the close of the plan year for which the waiver is requested. However, there is a transitional rule for plan years beginning in calendar year 1988, that permits requests to be filed on or before the 15th day of the 6th month following the close of the plan year for which the waiver is requested. Accordingly, the first sentence of the first paragraph of section 4 of Rev. Proc. 83-41 is replaced by the following sentences:

"A waiver request for a plan year beginning on or before December 31, 1987, must be submitted no later than the close of the plant year following the plan year for which the waiver is requested. A waiver request for a plan year beginning after December 31, 1987, and before January 1, 1989, must be submitted no later than the 15th day of the 6th month following the close of the plan year. All other waiver requests must be submitted no later than the 15th day of the 3rd month following the close of the plan year for which the waiver is requested."

.11 Rev. Proc. 88-5 is changed to insert a new section immediately after the new section 6, which reads as follows.

"SEC. 7. TEMPORARY HARDSHIP AT THE CONTROLLED GROUP LEVEL

Sec. 2.03 of Rev. Proc. 83-41 is changed by inserting after the term "employer" where it first appears in the first sentence the phrase:

'and all other entities included within the controlled group of which the employer is a member'.

Sec. 2.03(b) of Rev. Proc. 83-41 is changed by inserting after the term employer in the first sentence the phrase:

'and all other entities included within the controlled group of which the employer is a member.' "

.12 Section 6 of Rev. Proc. 88-5 is renumbered to be section 8 and the following sentences are added to that renumbered section.

"The provision in section 4 requiring that participants, beneficiaries and alternate payees be notified of waiver requests and the provision in section 4 requiring that such notification include a description of the extent to which guaranteed benefits and benefit liabilities are funded are applicable to requests submitted on or after March 22, 1988. The effective date of the provisions in section 6 with respect to timely filing of waiver requests is based on the plan year for which the waiver is requested as stated in that section."

.13 Section 7 of Rev. Proc. 88-5 is renumbered to be section 9.

SEC. 4. DRAFTING INFORMATION

The principal author of this revenue procedure is Paul Nassal of the Employee Plans Technical and Actuarial Division. For further information regarding this revenue procedure contact the Employee Plans Technical Assistance Number on (202) 566-6783 between 2:00 and 4:00 p.m. Eastern time (*not* a toll-free call). Mr. Nassal's telephone number is (202) 566-3149 (also not a toll-free call).

SEC. 5. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 88-5 is modified as indicated above and will appear as so modified in Cumulative Bulletin 1988-1. Attached below is the complete text of Rev. Proc. 88-5 as modified:

SECTION 1. PURPOSE

The purpose of this revenue procedure is to modify the procedures for applications for waivers of the minimum funding standard under section 412(d) of the Internal Revenue Code and section 303 of the Employee Retirement Income Security Act of 1974 (ERISA), Public Law 93-406, 1974-3 C.B. 1, 41. The modifications will reflect changes made by the Single-Employer Pension Plan Amendments Act (SEPPAA), Title XI of the Consolidated Omnibus Budget Reconciliation Act of 1985, Public Law 99-272, 1986-2 C.B. 298, and the changes made by the Pension Protection Act, Part II of subtitle D of title IX of the Omnibus Budget Reconciliation Act of 1987 (OBRA), Public Law 100-203.

SEC. 2. BACKGROUND INFORMATION

.01 Revenue Procedure 83-41, 1983-1 C.B. 725, describes the procedure for requesting a waiver of the minimum funding standard under section 412(d) of the Code. Section 2.02 of the Revenue Procedure states that a request will not be considered unless certain specific documents described therein are included in the waiver application. Section 2.03 of the Revenue Procedure describes the necessary information that must be furnished by the applicant for the waiver.

.02 SEPPAA modified the provisions of the Code with respect to requirements relating to waivers. In particular, SEPPAA (1) added section 412(f)(3)(B) and (C) to require that the Service consult with the Pension Benefit Guaranty Corporation (PBGC) before granting or modifying a waiver under subsection 412(d) where the cumulative outstanding balance of the amount of waived funding deficiencies for a plan plus the amount of the waiver currently requested equals or exceeds $2,000,000 and (2) added section 412(f)(4), which provides that the Secretary, before granting a waiver under subsection 412(d) shall require each applicant to provide evidence satisfactory to the Secretary that the applicant has provided notice of the filing of the application for such waiver to each employee organization representing employees covered by the affected plan. OBRA modified section 412(f)(3) of the Code by striking out "$2,000,000" and inserting in lieu thereof "$1,000,000". In addition, OBRA amended section 412(f)(4)(A) of the Code to require that notice of application for a funding waiver also be given to each participant, beneficiary and alternate payee (within the meaning of section 414(p)(8)). Section 412(f)(4) also provides that the Secretary shall consider any relevant information provided by a person to whom such notice was given.

SEC. 3. CONSULTATION WITH PBGC

.01 Section 412(f)(3)(B) and (C) of the Code, as added by SEPPAA, requires that the Service provide the PBGC with notice of the completed application for any waiver and an opportunity to comment on such application within 30 days after receipt of such notice. Any information provided to the PBGC as a result of this provision shall be considered tax return information and is subject to the safeguards and reporting requirements of section 6103(p). The Service is not required to notify PBGC regarding applications where the outstanding balance of the amount of waived funding deficiencies for prior plan years plus the amount for which a waiver is currently requested is less than $2,000,000. This $2,000,000 threshold was reduced to $1,000,000 by OBRA.

.02 To expedite the procedures necessary to satisfy this requirement, section 2.03(d)(15) of Revenue Procedure 83-41 is modified to read as follows:

"(15) A list of each of the prior 15 years for which a waiver was granted, the amount waived for such plan year, the outstanding balance of the amortization base established for the waiver, and the conditions, if any, placed upon the waiver. A copy of each waiver ruling letter must be submitted with the waiver request. The outstanding balance of the amortization base for each waiver is to be calculated as of the first day of the plan year for which a waiver is being requested."

.03 In addition, the first paragraph of section 2.03 of Revenue Procedure 83-41 is modified to add at the end thereof the following new sentence:

"If the sum of the outstanding balances of any amortization bases established under section 412(b)(2)(C) of the Code for waivers granted to the plan for any prior plan years (calculated as of the first day of the plan year for which a new waiver is being requested) when added to the amount for which a waiver is currently being requested, equals or exceeds $1,000,000, the applicant must furnish two copies of the necessary waiver information described in this section 2.03."

SEC. 4. PROCEDURES FOR NOTICE AND SUBMISSION OF RELEVANT INFORMATION

Section 412(f)(4) states that the Secretary shall require each applicant for a waiver to demonstrate that the applicant has notified each employee organization representing employees covered by the affected plan that a waiver application has been filed. Accordingly, section 2.02 of Revenue Procedure 83-41 is modified to substitute a comma for the word "and" between "(1) and (2)" in the first sentence, insert after "(2)" the words "and (3)," and to add the following paragraph (3):

"(3) The taxpayer must provide as part of the application a copy of a written notification signed by an appropriate officer of the taxpayer to each employee organization (union) representing employees covered by the affected plan and each participant, beneficiary, and alternate payee (within the meaning of section 414(p)(8) of the Code) that an application for a waiver of the minimum funding standard under section 412(d) of the Code has been submitted to the Service. The individual notice to participants, beneficiaries, and alternate payees may be in the form of a copy of a general notice which was signed by an appropriate officer of the company. The applicant must state that such notice was hand delivered or mailed to the last known address of the appropriate employee organization, participant, beneficiary, and alternate payee. If the applicant makes a reasonable effort to carry out the provisions of this paragraph, failure of an employee organization, participant, beneficiary, or alternate payee to receive the notice will not cause the applicant to fail the notice requirement. However, merely posting the notice on a bulletin board is not sufficient to satisfy this requirement. The notice must state that, under section 412(f)(4)(B) of the Code, the Service will consider any relevant information submitted. Further, the notice must specify the address to which information may be sent to the Service and state that because of the disclosure restrictions of section 6103 of the Code, the Service will not provide any information with respect to the waiver. The notice must also state that in accordance with section 104 of ERISA and section 2520.104b-10 of the Department of Labor regulations (29 CFR Part 2520) annual financial reports for the plan which include employer contributions made to the plan and the accumulated funding deficiency for the plan for any year are available for inspection at the U.S. Department of Labor in Washington, D.C., and that copies of such reports may be obtained upon request from the Public Disclosure Room, Room N-5507, Pension and Welfare Benefits Administration, U.S. Department of Labor, 200 Constitution Ave., N.W., Washington, D.C. 20210, upon payment of copying costs. In addition, the notice must state that copies of the latest annual report are available for inspection at the principal office of the plan administrator and any other location as required under section 104(b)(2) of the Employee Retirement Security Act of 1974 and the street address of such location. The notice must also state that copies of the annual report may be obtained from the plan administrator at a reasonable charge. The address to which requests for such copies may be sent and the amount of the charge must be stated. In addition, the notice must include a description of the extent to which the plan is funded for benefits which are guaranteed under Title IV of ERISA and the extent to which the plan is funded for benefit liabilities. Generally, this is satisfied if the notice includes the present value of the vested benefits, the present value of benefits determined as though the plan terminated, and the fair market value of plan assets, using the interest rate for calculating current liability. No additional information is required by the Service to be furnished to plan participants, beneficiaries, alternate payees or employee organizations as part of the waiver application process. Additional information may, of course, be provided by the employer pursuant to the collective bargaining process or otherwise.

SEC. 5. SUBMISSION OF COMMENTS

.01 Section 412(f)(4)(B), as added by SEPPAA, provides that the Secretary shall consider any relevant information provided by a person to whom notice was given as described in section 4 above. Section 6103 of the Internal Revenue Code prohibits the Service from disclosing return information with respect to any taxpayer. Accordingly, absent a disclosure waiver the Service may not reveal any part of the contents of any waiver application to any individual who wishes to submit relevant information concerning a waiver application. Moreover, the Service can neither confirm nor deny that a request for a waiver of the minimum funding requirement with respect to any particular pension plan has or has not been received.

.02 All relevant information submitted should be submitted in writing to the Commissioner of Internal Revenue, Attention: E:EP:PA; 1111 Constitution Avenue, N.W., Washington, D.C. 20224. Although no specific time period is provided within which the information is to be submitted, such information should be submitted as soon as possible after notice is received that a waiver application has been filed.

.03 The Service will not suspend action on a waiver request in order to wait for information from employee organizations. If, however, a ruling letter has been issued to the applicant and information is later submitted, the Service will review the information so submitted and revoke or modify the ruling letter if it is deemed appropriate to do so. Generally, information submitted will not cause a revocation or modification of the ruling letter unless the information indicates that there was a material omission or misstatement of facts.

SEC. 6. TIME WHEN APPROPRIATE TO REQUEST A WAIVER

Section 414(d), as amended by OBRA, requires that an employer (other than an employer maintaining a multiemployer plan) seeking a minimum funding waiver for a plan year beginning after December 31, 1987, must submit the request on or before the 15th day of the 3rd month following the close of the plan year for which the waiver is requested. However, there is a transitional rule for plan years beginning in calendar year 1988, that permits requests to be filed on or before the 15th day of the 6th month following the close of the plan year for which the waiver is requested. Accordingly, the first sentence of the first paragraph of section 4 of Rev. Proc. 83-41 is replaced by the following sentences:

> "A waiver request for a plan year beginning on or before December 31, 1987, must be submitted no later than the close of the plan year following the plan year for which the waiver is requested. A waiver request for a plan year beginning after December 31, 1987, and before January 1, 1989, must be submitted no later than the 15th day of the 6th month following the close of the plan year. All other waiver requests must be submitte no later than the 15th day of the 3rd month following the close of the plan year for which the waiver is requested."

SEC. 7. TEMPORARY HARDSHIP AT THE CONTROLLED GROUP LEVEL

Sec. 2.03 of Rev. Proc. 83-41 is changed by inserting after the term "employer" where it first appears in the first sentence the phrase:

> "and all other entities included within the controlled group of which the employer is a member".

Sec. 2.03(b) of Rev. Proc. 83-41 is changed by inserting after the term employer in the first sentence the phrase:

> "and all other entities included within the controlled group of which the employer is a member."

SEC. 8. EFFECTIVE DATE

This revenue procedure is effective for all ruling requests received after the date of its publication in the Internal Revenue Bulletin. The provision in section 4 requiring that participants, beneficiaries and alternate payees be notified of waiver requests and the provision in section 4 requiring that such notification include a description of the extent to which guaranteed benefits and benefit liabilities are funded are applicable to requests submitted on or after March 22, 1988. The effective date of the provisions in section 6 with respect to timely filing of waiver requests is based on the plan year for which the waiver is requested as stated in that section.

SEC. 9. EFFECT ON OTHER REVENUE PROCEDURES

Revenue Procedure 83-41 is modified.

---

26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 25, 103, 143; 1.25-1T, 1.103-1, 6a.103A-2.)

Rev. Proc. 88-30

SECTION 1. PURPOSE

This revenue procedure modifies the average area purchase price safe harbor limitations for new and existing single-family residences for the State of Iowa as published in Rev. Proc. 87-20, 1987-1 C.B. 713.

SEC. 2. BACKGROUND

Issuers of qualified mortgage bonds, as defined in section 143(a) of the Internal Revenue Code, and issuers of mortgage credit certificates, as defined in section 25(c), must satisfy several requirements contained in section 143. One of the requirements is that the cost of each residence must not exceed a certain percentage of the average area purchase price applicable to such residence. Section 143(e). Issuers of qualified mortgage bonds and mortgage credit certificates may rely on the average area purchase price safe harbor limitations contained in Rev. Proc. 87-20 for purposes of satisfying the purchase price requirement. However, the average area purchase price safe harbor limitations published in Rev. Proc. 87-20 for Iowa have been determined to be incorrect. Therefore, corrected safe harbor limitations are set forth in section 3 of this revenue procedure.

SEC. 3. APPLICATION

Section 3.04 of Rev. Proc. 87-20 is modified by deleting the average area purchase price safe harbor limitations for "all areas" in the State of Iowa of $54,700 for new single-family residences and $64,600 for existing single-family residences and substituting $81,800 for new single-family residences and $58,500 for existing single-family residences.

SEC. 4. EFFECTIVE DATE

.01 Subject to subsections .02 and .03, the modifications made by this revenue procedure are effective as if they were contained in Rev. Proc. 87-20.

.02 Pursuant to the authority contained in section 7805(b) of the Code, the corrected average area purchase price safe harbor limitation for existing single-family residences for Iowa set forth in this revenue procedure does not apply to qualified mortgage bonds sold before July 13, 1988, 30 days after publication of this revenue procedure in the Internal Revenue Bulletin, if commitments to provide financing for the mortgages are made before September 11, 1988, 90 days after publication of this revenue procedure in the Internal Revenue Bulletin.

.03 Pursuant to the authority contained in section 7805(b) of the Code, the corrected average area purchase price safe harbor limitation for existing single-family residences for Iowa set forth in this revenue procedure does not apply if mortgage credit certificates are issued with respect to bond authority exchanged before the earlier of (1) July 13, 1988, 30 days after publication of this revenue procedure in the Internal Revenue Bulletin, or (2) the date following the termination date set forth in section 25(h), and if the commitments to issue the certificates are made before September 11, 1988, 90 days after the publication of this revenue procedure in the Internal Revenue Bulletin.

SEC. 5. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 87-20 is modified.

---

26 CFR 601.201: Rulings and determination letters.

(Also Part I, Sections 103, 143; 1.103-1, 6a.103A-2.)

Rev. Proc. 88-31

SECTION 1. PURPOSE

The purpose of this revenue procedure is to set forth procedures for requesting approval of a state designation of an area as an "area of chronic economic distress" under section 143(j)(3)(A)(ii) of the Internal Revenue Code.

SEC. 2. BACKGROUND

.01 Section 103(a) of the Code provides that, except as provided in section 103(b), gross income does not include interest on any state or local bond. Section 103(b)(1) provides that section 103(a) shall not apply to any private activity bond that is not a qualified bond. Section 141(e)(1)(B) provides that the term "qualified bond" includes a qualified mortgage bond.

.02 Section 143(a)(1)(A) of the Code provides that the term "qualified mortgage bond" means a bond that is issued as part of a qualified mortgage issue. Section 143(a)(2)(A) provides that the term "qualified mortgage issue" means an issue by a state or political subdivision thereof of one or more bonds, but only if (i) all proceeds of such issue (exclusive of issuance costs and a reasonably required reserve) are to be used to finance owner-occupied residences; (ii) such issue meets the requirements of subsections (c), (d), (e), (f), (g), (h), and (i); and (iii) such issue does not meet the private business tests of paragraphs (1) and (2) of section 141(b).

.03 An issue meets the requirements of subsection (h) of section 143 of the Code only if at least 20 percent of the proceeds of the issue that are devoted to owner-financing is made available (with reasonable diligence) for owner-financing of targeted area residences for at least 1 year after the date on which owner-financing is first made available with respect to targeted area residences. However, the amount made available need not exceed 40 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family, owner-occupied residences located in targeted areas within the jurisdiction of the issuing authority. Section 143(j)(1)(B) defines a targeted area residence to include a residence in an area of chronic economic distress. Section 143(j)(3)(A) defines an "area of chronic economic distress" as an area of chronic economic distress (i) designated by the state as meeting standards established by the state for the purposes of subsection (j), and (ii) the designation of which has been approved by the Secretary and the Secretary of Housing and Urban Development.

.04 Section 143(j)(3)(B) of the Code provides that the criteria used by the Secretary and the Secretary of Housing and Urban Development in evaluating any proposed designation of an area will be as follows:

(i) the condition of the housing stock, including the age of the housing and the number of abandoned and substandard residential units,

(ii) the need of area residents for owner-financing under section 143, as indicated by low per capita income, a high percentage of families in poverty, a high number of welfare recipients, and high unemployment rates,

(iii) the potential for use of owner-financing under section 143 to improve housing conditions in the area, and

(iv) the existence of a housing assistance plan that provides a displacement program and a public improvements and services program.

.05 Section 6a.103A-2(b)(5)(iii) of the Temporary Income Tax Regulations (issued under former section 103A(k) of the Code, the predecessor of section 143(j)) sets forth the criteria that will be used in evaluating a proposed designation of an area of chronic economic distress. Section 6a.103A-2(b)(5)(iv) lists the information that must be contained in a proposal by a state that an area be approved as an area of chronic economic distress.

.06 A state or local government may elect to exchange all or part of its qualified mortgage bond authority for authority to issue mortgage credit certificates. *See* section 1.25-1T(a) of the Temporary Income Tax Regulations. In general, if such an election is made, section 25(a) of the Code will allow the recipient of a mortgage credit certificate to claim a credit against the recipient's federal income tax in an amount equal to the product of the certificate credit rate and the interest paid or accrued by the recipient during the taxable year on the remaining principal of the certified indebtedness amount. Section 25(c)(2)(A)(iii)(V) provides that the indebtedness certified by mortgage credit certificates must meet the requirements relating to the portion of loans that must be placed in targeted areas under section 143(h) (as modified by section 25(c)(2)(B).

.07 Section 143(a)(1)(B) of the Code provides that no bond issued after December 31, 1988, may be treated as a qualified mortgage bond.

SEC. 3. PROCEDURE

.01 A request for approval of a state designation of an area as an "area of chronic economic distress" under section 143(j)(3)(A)(ii) of the Code must be submitted by the state in triplicate to the Assistant Secretary for Housing/Federal Housing Commissioner of the Department of Housing and Urban Development (Attention: Office of Financial Management, Financial Policy Division, Room 9132, 451 7th Street, S.W., Washington, D.C. 20410).

.02 The approval or disapproval by the Assistant Secretary for Housing/Federal Housing Commissioner of the Department of Housing and Urban Development (HUD) of the state designation of an area as an "area of chronic economic distress" will be transmitted for concurrence or comment to the Associate Chief Counsel (Technical and International), Internal Revenue Service, Attention: CC:IND:2, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. The Internal Revenue Service (IRS) generally will respond in writing to HUD within 10 working days of the receipt of HUD's approval or disapproval.

.03 If the state desires a conference because of an adverse decision on the proposed designation, representatives of HUD and IRS will attend the conference.

.04 HUD will issue the response to the state's request for approval of the state designation of an area as an "area of chronic economic distress."

.05 If the state, as an issuer of mortgage revenue bonds, requests a ruling concerning a prospective issue of mortgage revenue bonds that addresses requirements in addition to those pertaining to the approval of a state designation of "areas of chronic economic distress," the issuer must submit a separate request relating to the approval of the state designation of "areas of chronic economic distress" and must follow the procedures set forth in this revenue procedure. The request pertaining to the other requirements applicable to the prospective issue of mortgage revenue bonds must follow the procedures set forth in Rev. Proc. 88-32, this page, this Bulletin. Only by following the procedures set forth in this revenue procedure and in Rev. Proc. 88-32, will the issuer be treated as having exhausted its administrative remedies and be able to seek a declaratory judgment from the United States Tax Court under section 7478 of the Code involving a determination by the IRS (or the failure by IRS to make a determination) whether prospective obligations are described in section 103(a). Even though a letter may be issued by HUD approving or disapproving the designation of a geographic area as an area of chronic economic distress, an issuer will in no event be deemed to have exhausted its administrative remedies for purposes of section 7478 until the earlier of the times set forth in section 6.02 of Rev. Proc. 88-32.

.06 If an issuer, other than the state, desires to request a ruling that a prospective issue of mortgage revenue bonds will satisfy all the requirements necessary for the bonds to be described in section 103(a) of the Code, and a request for approval of state designated "areas of chronic economic distress" has already been considered by HUD and the IRS, the issuer must follow the procedures set forth in Rev. Proc. 88-32, this page, this Bulletin.

.07 If a person (other than the issuer) with a material financial interest in the issuance of prospective mortgage revenue bonds desires to request a ruling on questions relating to the bonds other than the state designation of a geographic area as an "area of chronic economic distress," a separate request for such questions must be submitted to the IRS. Such request must comply with the requirements of Rev. Proc. 88-1, page 557, this Bulletin; Rev. Proc. 88-33, page 835, this Bulletin; and Rev. Proc. 88-3, page 579, this Bulletin.

.08 If an issuer of, or a person (other than the issuer) with a material financial interest in, an outstanding issue of mortgage revenue bonds desires to request a ruling on questions relating to the bonds, such request must comply with the requirements of Rev. Proc. 88-1, Rev. Proc. 88-33, and Rev. Proc. 88-3.

SEC. 4. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 81-30 is amplified and superseded.

---

26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 103, 7478; 1.103-1.)

Rev. Proc. 88-32

SECTION 1. PURPOSE

The purpose of this revenue procedure is to set forth procedures for the submission of requests for rulings to the Internal Revenue Service under sections 103 and 7478 of the Internal Revenue Code and to update the procedures described in Rev. Proc. 84-48, 1984-1 C.B. 547. References in this revenue procedure to section 103 of the Code also refer to sections 141-150 and 7871.

SEC. 2. BACKGROUND

.01 Section 7478 of the Code provides that under the conditions specified therein, the issuer (and only the issuer) of prospective obligations may petition the United States Tax court for a declaratory judgment in a case of actual controversy involving a determination by the Service, or a failure by the Service to make a determination, with respect to whether prospective obligations are described in section 103(a).

.02 The Tax Court may not issue a declaratory judgment or decree under section 7478 of the Code in any proceeding unless it determines that the issuer of the prospective obligations has exhausted all available administrative remedies within the Service.

.03 Any ruling request that is made by an issuer with respect to prospective obligations is subject to section 7478 of the Code and, accordingly, must be made in full compliance with this revenue procedure. Procedures for the submission of ruling requests when the requester of the ruling is not the issuer, or when the request relates to outstanding obligations, are set forth in Rev. Proc. 88-33, page 835, this Bulletin.

.04 Section 10511 of the Revenue Act of 1987, 1987-3 C.B. ____ , provides that a user fee must be paid with respect to requests to the Service for rulings. Also see Rev. Proc. 88-8, page 628, this Bulletin.

SEC. 3. REQUESTS FOR RULINGS UNDER SECTIONS 103 AND 7478

.01 A request for a ruling under sections 103 and 7478 of the Code is to be submitted and signed, under the penalty of perjury, (1) by an authorized officer of the issuer, or (2) in the case of a joint submission, by both an authorized officer of the issuer and a party with a material financial interest in the issuance of the prospective obligations.

.02 In those instances in which an authorized representative is retained, the request for a ruling must be submitted with powers of attorney that are properly executed and that are signed (1) by an authorized officer of the issuer, or (2) in the case of a joint submission, by both an authorized officer of the issuer and a party with a material financial interest in the issuance of the prospective obligations.

.03 Each request for a ruling must contain a complete and detailed statement of all facts relating to the prospective obligations and must comply with the requirements of Rev. Proc. 88-1, page 557, this Bulletin (or its successor), to the extent that revenue procedure is not inconsistent with this revenue procedure. Each request for a ruling must be submitted in duplicate and must be accompanied by two copies of all relevant documents, including copies of state statutes, appropriate bond resolutions adopted in accordance with state or local law authorizing the issuance of the bonds, bond indentures, leases, management contracts, output contracts, and other agreements. Relevant facts reflected in the documents submitted must be included in the body of the ruling request and not merely incorporated by reference and must be accompanied by an analysis of their bearing on the pertinent issues specifying pertinent provisions. In addition, in order to assist the Internal Revenue Service in making the deletions required by section 6110(c) of the Code, each request for a ruling must be accompanied by a deletion statement submitted in accordance with section 601.201 of the Statement of Procedural Rules (26 CFR Part 601).

.04 Each request for a ruling must contain a statement of all reasons and legal authority that are pertinent in determining whether the prospective obligations are described in section 103(a) of the Code. Thus, for example, a request for a ruling that interest on prospective obligations to provide for construction of a facility for the furnishing of water will be excludable from gross income under section 103(a) must contain a statement of facts, reasons, and legal authority that will enable the Service to determine whether the prospective obligations will be (1) issued by or on behalf of a state or political subdivision thereof, (2) private activity bonds within the meaning of section 141, (3) part of an issue 95 percent or more of the net proceeds of which will be used to provide facilities described in section 142(a)(4), (4) part of an issue that meets the volume cap requirement under section 146, (5) obligations not held by persons described in section 147(a)(1), (6) part of an issue that meets the maturity requirements of section 147(b), (7) part of an issue that meets the limitation on use for land acquisition of section 147(c), (8) part of an issue that meets the requirements concerning the acquisition of existing property in section 147(d), (9) part of an issue no portion of which is to be used to provide property described in section 147(e), (10) part of an issue that satisfies the public approval requirement of section 147(f), (11) part of an issue that satisfies the restrictions on issuance costs in section 147(g), (12) obligations that are not arbitrage bonds within the meaning of section 148, (13) obligations that are in registered form within the meaning of section 149(a), (14) obligations that are not federally guaranteed within the meaning of section 149(b), and (15) part of an issue that meets the information reporting requirements under section 149(e).

.05 If a request for a ruling under this revenue procedure requires the approval of a state designation of a geographic area as an "area of chronic economic distress" as required by section 143(j)(3)(A)(ii) of the Code, the requirements set forth in Rev. Proc. 88-31, page 832, this Bulletin, also must be satisfied along with the requirements in this revenue procedure.

SEC. 4. ISSUING RULING LETTERS

.01 The 180-day period referred to in section 7478(b)(2) of the Code generally will be considered to begin on the date that a ruling request that complies with section 3 of this revenue procedure is received by the National Office of the Internal Revenue Service. Upon receipt of a request for a ruling, the Service will send a written acknowledgment to the requester. If a request for a ruling does not comply with all the requirements of section 3, it will not be processed further and the requester will be sent a letter that will point out the requirements that have not been met. The 180-day period will not be considered as starting until the date an amended request for ruling containing the additional information requested by the Service is received by the National Office of the Internal Revenue Service.

.02 Although the Service may initially determine that a request for a ruling complies with section 3 of this revenue procedure and thus begins the 180-day period described above, the Service may, nevertheless, request additional information in support of a request for ruling. A failure to timely submit additional information requested by the Service will be considered a failure to exhaust administrative remedies within the meaning of section 7478(b)(2) of the Code. Additional information or statements of legal authority will be considered timely submitted to the National Office of the Internal Revenue Service if the letter containing such information is sent within 30 days after the date the additional information is requested. The additional information or statements of legal authority must be signed and submitted in the manner set forth in section 3.01 of this revenue procedure.

.03 Any oral representation of additional facts or modification of the facts as represented or alleged in the request for ruling must be confirmed by letter to the National Office of the Internal Revenue Service, under the penalty of perjury, within 7 days after the oral representation or modification by the issuer and, in the case of a joint submission, by a party with a material financial interest and the issuer. Failure to submit a written statement of the oral representation of additional facts or modification of the facts within the time set forth in this subsection will be considered a failure to exhaust administrative remedies within the meaning of section 7478(b)(2) of the Code.

.04 Requests for rulings will be considered to be sent to the National Office of the Internal Revenue Service if addressed to the Internal Revenue Service, Associate Chief Counsel (Technical and International), Attention: CC:IND:D:C, SECTION 103 REQUEST, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044. Requests may be hand delivered to Room 6561, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

.05 Additional correspondence or documents (including withdrawals of requests for rulings) submitted with respect to requests for rulings will be considered to be sent to the National Office of the Internal Revenue Service if addressed as follows: ADDITIONAL INFORMATION, Attorney/Tax Law Specialist, CC:IND:2, Room 5314, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044.

SEC. 5. WITHDRAWAL OF REQUESTS FOR RULINGS

.01 All withdrawals of requests for rulings must be sent in writing to the National Office of the Internal Revenue Service by the issuer or its authorized representative. The withdrawal is not a failure to make a determination within the meaning of section 7478(a)(2) of the Code or an exhaustion of administrative remedies within the meaning of section 7478(b)(2).

SEC. 6. EXHAUSTION OF ADMINISTRATIVE REMEDIES

.01 Section 7478 of the Code requires that an issuer must exhaust its administrative remedies by taking, in a timely manner, all reasonable steps to secure a determination. Those steps and administrative remedies required to be exhausted within the Service are:

(1) The filing of a request for ruling that complies with section 3 of this revenue procedure; and

(2) The timely submission, in writing, of all additional information or representation of additional facts or modification of facts requested by the Service to process the request for ruling.

.02 An issuer will in no event be deemed to have exhausted its administrative remedies prior to the earlier of:

(1) The date that the Internal Revenue Service sends by certified or registered mail notice of a determination that the prospective obligations are not described in section 103(a) of the Code; or

(2) The expiration of the 180-day period described in section 7478(b)(2) of the Code in a case in which the Service has not made a determination whether the prospective obligations are described in section 103(a), and the issuer has completed the steps in section 6.01 of this revenue procedure.

SEC. 7. NOTICE OF DETERMINATION

.01 A notice of determination to which section 7478 of the Code applies is a ruling letter, sent by certified or registered mail, that holds that prospective obligations are not described in section 103(a) of the Code.

SEC. 8. INQUIRIES

.01 Inquiries with respect to this revenue procedure should refer to its number and should be addressed to the Internal Revenue Service, Associate Chief Counsel (Technical and International), Attention: CC:IND:2, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

SEC. 9. EFFECT ON OTHER DOCUMENTS

This revenue procedure supplements Rev. Proc. 88-1 and supersedes Rev. Proc. 84-48.

---

26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 103, 148, 7478; 1.103-1, 1.103-13.)

Rev. Proc. 88-33

SECTION 1. PURPOSE

The purpose of this revenue procedure is to update the procedures under Rev. Proc. 84-49, 1984-1 C.B. 548, for submission of requests for rulings to the Internal Revenue Service under section 103 of the Internal Revenue Code when the requester of the ruling is not the issuer, or when the request relates to outstanding obligations. This revenue procedure also updates and amplifies Rev. Proc. 84-50, 1984-1 C.B. 550, which sets forth the procedures for requesting a ruling to which certain of the arbitrage provisions under former section 103(c) (now section 148) apply when the requester is other than the issuer of the prospective obligations. See Rev. Proc. 88-32, page 833, this Bulletin, for the procedures when the issuer of prospective obligations requests a ruling from the Service. References to section 103 of the Code also refer to sections 141-150 and 7871 of the Code.

SEC. 2. BACKGROUND

.01 Section 103(a) of the Code provides that, except as provided in subsection (b), gross income does not include interest on any state or local bond. Section 7478 provides that the issuer of the prospective obligations may petition the United States Tax Court for a declaratory judgment in a case of actual controversy involving a determination by the Service, or a failure by the Service to make a determination, with respect to whether prospective obligations are described in section 103(a). After the obligations have been issued, the issuer may no longer obtain a declaratory judgment under section 7478. The issuer then may seek a ruling under this revenue procedure. See section 3.04 below.

.02 Historically, the Service has issued rulings under section 103 of the Code to an issuer of obligations and other parties with a material financial interest in the issuance. In addition, it has been the practice of the Service to issue rulings, in its discretion, that address only certain issues pertaining to whether an obligation is described in section 103(a). In the case of a ruling request that addressed only certain issues, the request would contain a statement of facts, reasons, and legal authority, together with supporting documents, that would discuss only the issue raised by the person requesting the ruling and would not address other issues pertaining to whether the obligations were described in section 103(a). In response to such requests, the Service might issue a ruling in which it would determine, for example, that a dock financed by governmental obligations was a facility described in section 142(a)(2), but would not express an opinion with respect to whether the prospective obligations were otherwise described in section 103(a).

.03 However, in light of the provisions of section 7478 of the Code, the Service has set forth procedures in Rev. Proc. 88-32, page 833, this Bulletin, that preclude the issuance of a ruling to an issuer of prospective obligations (or to an issuer and another party in a joint submission) unless the issuer has submitted a statement of facts, reasons, and legal authority, together with supporting documents, that address all issues pertaining to whether the prospective obligations are described in section 103(a). See section 3.04 of Rev. Proc. 88-32. The reason for the requirements set forth in Rev. Proc. 88-32 is that, under section 7478, the issuer of the prospective obligations may petition the United States Tax Court to determine whether the prospective obligations are described in section 103(a). See section 2.01 of Rev. Proc. 88-32. Because that determination involves an examination of all issues pertaining to the status of the prospective obligations, the Service must in the ruling process examine and address all issues pertaining to whether the prospective obligations are described in section 103(a).

.04 Section 10511 of the Revenue Act of 1987, 1987-3 C.B. ___ , provides that a user fee must be paid with respect to requests to the Service for rulings. Also see Rev. Proc. 88-8, page 628, this Bulletin.

SEC. 3. APPLICATION

.01 In the case of requests for rulings made by a person (other than the issuer) with a material financial interest in the issuance of the obligations, to which neither section 3.02 of Rev. Proc. 88-32 (joint submission) nor section 3.03 of this revenue procedure (requester subsequently joined by issuer) applies, the Service will continue to issue rulings that address a specific issue pertaining to whether prospective obligations are described in section 103(a) of the Code. Further, the Service will continue to issue rulings to these requesters in those situations in which the Income Tax Regulations require or permit the issuer to request a ruling. For example, a party that has a material financial interest in the issue may request a ruling that a single computation of yield may be made pursuant to section 1.103-13(c)(1)(ii) of the regulations (issued under former section 103(c) of the Code). The Service also will issue rulings to these requesters as to whether prospective obligations are described in section 103(a). The requester must comply with the requirements of any other applicable revenue procedures, other than Rev. Proc. 88-32, that relate to submission to the Service of requests for ruling.

.02 In the case of requests for rulings by a person other than the issuer, the failure of the Service to issue a ruling or the issuance of an adverse ruling is not either a failure to make a determination within the meaning of section 7478(a)(2) of the Code or an exhaustion of administrative remedies by the issuer within the meaning of section 7478(b)(2).

.03 If, subsequent to the date a person other than the issuer requests a ruling, the issuer of the prospective obligations joins in the request, the Service will treat the request as a joint submission by the issuer and the original requester and the requirements set forth in Rev. Proc. 88-32 must be satisfied. The Service will notify in writing the joint requesters of any additional information or documents required. In the case of requests for rulings that are subject to the provisions of this subsection, the 180-day period referred to in section 7478(b)(2) of the Code will be considered to begin on the later of the date the issuer joins in the request or the date set forth in section 4.01 of Rev. Proc. 88-32.

.04 In the case of requests for rulings with respect to outstanding obligations made by the issuer or a person (other than the issuer) with a material financial interest in the issuance of the obligations, the Service will continue to issue rulings that address one or more issues pertaining to whether the outstanding obligations are described in section 103(a) of the Code. The request for ruling must comply with the requirements of any other revenue procedures, other than Rev. Proc. 88-32, that relate to the submission to the Service of requests for a ruling. If interest has been paid on the obligation, the Service will determine whether the subject of the request should be processed as a ruling request in the National Office or should be referred to the district director having jurisdiction over the matter.

SEC. 4. INQUIRIES

.01 Inquiries with respect to this revenue procedure should refer to its number and should be addressed to the Internal Revenue Service, Associate Chief Counsel (Technical and International), Attention: CC:IND:2, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

SEC. 5. EFFECT ON OTHER DOCUMENTS

This revenue procedure supplements Rev. Proc. 88-1, page 557, this Bulletin, supersedes Rev. Proc. 84-49, and amplifies and supersedes Rev. Proc. 84-50.

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 88-34

SECTION 1. PURPOSE

Section 5 of Rev. Proc. 88-3, page 579, this Bulletin, contains a list of those areas of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Technical and International) in which advance rulings or determination letters will not be issued because the matter is under extensive study. This revenue procedure modifies Rev. Proc. 88-3 by deleting section 5.14, relating to status as an 80-percent distributee as referred to in section 337(c).

SEC. 2. BACKGROUND

Under section 5.14 of Rev. Proc. 88-3, the Internal Revenue Service will not issue a ruling or determination letter as to whether section 1.1502-34 of the Income Tax Regulations (dealing with aggregation of stockholdings under consolidated return rules) is applicable in determining a corporate shareholder's status as an 80-percent distributee as referred to in section 337(c) of the Code.

This matter is no longer under study, and the Service will now rule on this question of the applicability of section 1.1502-34 in determining 80-percent distributee status for purposes of section 337(c) of the Code.

SEC. 3. PROCEDURE

Rev. Proc. 88-3 is modified by deleting section 5.14 in its entirety.

SEC. 4. COMMENTS OR INQUIRIES

Comments or inquiries regarding this revenue procedure should be addressed to the Associate Chief Counsel (Technical and International), Attention: CC:C:3, Internal Revenue Service, 1111 Constitution Ave., N.W., Washington D.C. 20224.

SEC. 5. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 88-3 is modified.

SEC. 6. EFFECTIVE DATE

This revenue procedure is effective June 27, 1988, the date of its publication in the Internal Revenue Bulletin.

---

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 88-35

SECTION 1. PURPOSE

This revenue procedure removes from the no-ruling list those rulings that relate to safe harbor leases.

SEC. 2. BACKGROUND

.01 Section 5 of Rev. Proc. 88-3, page 579, this Bulletin, contains a list of areas under extensive study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations, or otherwise.

.02 Section 5.09 of Rev. Proc. 88-3, which is entitled "Section 168(f)(8).—Special Rule for Leases.", includes in the "no-ruling list" certain areas that were specifically reserved in the Temporary Income Tax Regulations under the Economic Recovery Tax Act of 1981, relating to special rules for leases. The areas specifically reserved are:

(1) section 5c.168(f)(8)-8(b)(9)—retirements and casualties;

(2) section 5c.168(f)(8)-9—transfer of investment credit by section 168(f)(8) leases;

(3) section 5c.168(f)(8)-10—leases between related parties; and

(4) section 5c.168(f)(8)-11—consolidated returns.

.03 The Service has decided that no temporary or final regulations will be issued concerning the four no-ruling areas listed in section 5.09 of Rev. Proc. 88-3.

.04 Certain transactions, however, raise issues covered by the no-ruling areas listed in section 5.09 of Rev. Proc. 88-3 and are of sufficient significance to warrant issuance of rulings and determination letters. Accordingly, the Service will now entertain requests for rulings and determination letters on issues listed in section 5.09 of Rev. Proc. 88-3 to the extent appropriate.

SEC. 3. PROCEDURE

Rev. Proc. 88-3 is modified by deleting section 5.09.

SEC. 4. COMMENTS OR INQUIRIES

Comments or inquiries regarding this revenue procedure should be addressed to the Associate Chief Counsel (Technical and International), Attention: CC:C:2, Internal Revenue Service, 1111 Constitution Ave., N.W., Washington, D.C. 20224.

SEC. 5. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 88-3 is modified.

SEC. 6. EFFECTIVE DATE

This revenue procedure is effective June 27, 1988, the date of its publication in the Internal Revenue Bulletin.

26 CFR 601.602: Tax forms and instructions.

Rev. Proc. 88-36

NOTE: THIS REVENUE PROCEDURE MAY ONLY BE USED TO PREPARE MAGNETIC MEDIA SUBMISSIONS FOR TAX YEAR 1988 RETURNS. UPDATED COPIES ARE PUBLISHED EACH YEAR. PLEASE READ THIS PUBLICATION CAREFULLY. PERSONS REQUIRED TO FILE MAY BE SUBJECT TO PENALTIES FOR FAILURE TO FOLLOW THE INSTRUCTIONS IN THIS REVENUE PROCEDURE AND FOR FAILURE TO INCLUDE CORRECT INFORMATION ON A RETURN. A $5 PER RETURN PENALTY MAY BE IMPOSED FOR THE OMISSION OF INFORMATION AS WELL AS FOR THE INCLUSION OF INCORRECT INFORMATION. THE MAXIMUM PENALTY IS $20,000. (THERE IS NO MAXIMUM FOR CERTAIN INTEREST OR DIVIDEND RETURNS OR STATEMENTS.) YOU MAY ALSO BE SUBJECT TO PENALTIES OF $50 PER RETURN FOR EACH RETURN SUBMITTED WITHOUT A TAXPAYER IDENTIFICATION NUMBER (TIN) OR WITH AN INCORRECT TIN. AN ADDITIONAL $50 PENALTY PER RETURN MAY BE IMPOSED FOR EACH RETURN NOT SUBMITTED ON MAGNETIC MEDIA IF YOU ARE REQUIRED TO FILE THIS WAY OR IF YOU FILE LATE. THE MAXIMUM PENALTY IS $100,000 PER CALENDAR YEAR. (THERE IS NO MAXIMUM FOR FORMS 1099-INT, 1099-DIV, 1099-OID, 1099-PATR, 5498 OR IF THE FAILURE TO FILE IS DUE TO INTENTIONAL DISREGARD OF THE FILING AND CORRECT INFORMATION REQUIREMENTS). IF A $50 PENALTY IS IMPOSED, THE $5 PENALTY WILL NOT BE APPLIED FOR THE SAME RETURN. IRS STRONGLY ENCOURAGES FILERS TO REVIEW THEIR DATA FOR ACCURACY BEFORE SUBMISSION TO PREVENT ERRONEOUS NOTICES BEING MAILED TO PERSONS FOR WHOM REPORTS ARE FILED.

Contents

Part A. General

SECTION 1. PURPOSE
SECTION 2. NATURE OF CHANGES—CURRENT YEAR (TAX YEAR 1988)
SECTION 3. APPLICATION FOR MAGNETIC MEDIA REPORTING AND REQUESTS FOR UNDUE HARDSHIP WAIVERS
SECTION 4. FILING OF MAGNETIC MEDIA REPORTS AND RETENTION REQUIREMENTS
SECTION 5. FILING DATES
SECTION 6. EXTENSIONS OF TIME TO FILE
SECTION 7. PROCESSING OF MAGNETIC MEDIA RETURNS
SECTION 8. HOW TO FILE CORRECTED RETURNS
SECTION 9. TAXPAYER IDENTIFICATION NUMBERS
SECTION 10. EFFECT ON PAPER RETURNS
SECTION 11. HOW TO CONTACT THE IRS NATIONAL COMPUTER CENTER
SECTION 12. COMBINED FEDERAL/STATE FILING
SECTION 13. DEFINITIONS OF TERMS
SECTION 14. STATE ABBREVIATIONS

Part B. Magnetic Media Specifications

SECTION 1. GENERAL
SECTION 2. TAPE SPECIFICATIONS
SECTION 3. 51/4 INCH AND 31/2 INCH DISKETTE SPECIFICATIONS
SECTION 4. PAYER/TRANSMITTER "A" RECORD
SECTION 5. PAYER/TRANSMITTER "A" RECORD—RECORD LAYOUT
SECTION 6. PAYEE "B" RECORD-GENERAL FIELD DESCRIPTIONS AND RECORD LAYOUTS
SECTION 7. END OF PAYER "C" RECORD
SECTION 8. STATE TOTALS "K" RECORD
SECTION 9. END OF TRANSMISSION "F" RECORD

Part A.—General

Section 1. Purpose

.01 The purpose of this revenue procedure is to provide the requirements and conditions for filing Forms 1098, 1099, 5498, and W-2G on magnetic tape, *5¼ inch magnetic diskette, and 3½ inch magnetic diskette.* Other revenue procedures provide instructions for filing on 8 inch magnetic diskette. THIS REVENUE PROCEDURE IS TO BE USED FOR THE PREPARATION OF 1988 INFORMATION RETURNS ONLY. THIS PROCEDURE IS UPDATED YEARLY TO REFLECT NECESSARY CHANGES. PLEASE READ THIS PUBLICATION CAREFULLY. Specifications for filing the following forms are contained in this procedure:

(a) Form 1098, Mortgage Interest Statement.

(b) Form 1099-A, Information Return for Acquisition or Abandonment of Secured Property.

(c) Form 1099-B, Statement for Recipients of Proceeds From Broker and Barter Exchange Transactions.

(d) Form 1099-DIV, Statement for Recipients of Dividends and Distributions.

(e) Form 1099-G, Statement for Recipients of Certain Government Payments.

(f) Form 1099-INT, Statement for Recipients of Interest Income.

(g) Form 1099-MISC, Statement for Recipients of Miscellaneous Income.

(h) Form 1099-OID, Statement for Recipients of Original Issue Discount.

(i) Form 1099-PATR, Statement for Recipients (Patrons) of Taxable Distributions Received From Cooperatives.

(j) Form 1099-R, Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.

(k) *Form 1099-S, Statement for Recipients of Proceeds From Real Estate Transactions.*

(l) Form 5498, Individual Retirement Arrangement Information.

(m) Form W-2G, Statement for Recipients of Certain Gambling Winnings.

Specifications for filing Forms 1042S, 6248, 8027, W-2, and W-2P are contained in separate publications.

.02 All filing requirements that follow apply individually to each reporting entity as defined by its separate TIN (Social Security Number (SSN) or Employer Identification Number (EIN)). For example, if you are a corporation with several branches or locations and each uses the same EIN, you must aggregate the total volume of returns to be filed for that EIN and apply the filing requirements for each type of return accordingly.

Section 1.6045-1(l) of the Income Tax Regulations requires brokers and barter exchanges to use magnetic media to report ALL Form 1099-B data to IRS, *do not, however, report real estate transactions on Form 1099-B. Form 1099-S will be used to report real estate transactions. Magnetic media filing is required if 250 or more Forms 1099-S must be filed.* THESE REQUIREMENTS APPLY SEPARATELY TO BOTH ORIGINAL AND CORRECTED RETURNS.

Section 6011(e) of the Internal Revenue Code and the regulations thereunder require any person, including corporations, partnerships, individuals, estates, and trusts, who must file, or who were required to file for the prior year, more than 50 information returns *in the aggregate* for payments of interest (Forms 1099-INT and 1099-OID), dividends (Form 1099-DIV), or patronage dividends (Form 1099-PATR), for any calendar year, to file such returns on magnetic media. For example, if you must file 30 Forms 1099-DIV and 25 Forms 1099-INT, filing on magnetic media is required. THIS REQUIREMENT APPLIES SEPARATELY TO BOTH ORIGINAL AND CORRECTED RETURNS.

In addition, for returns filed in 1989 (for tax year 1988), magnetic media reporting is required if you file, or were required to file for the prior year, 250 or more of EACH of the following forms: Forms W-2, W-2P, W-2G, 1098, 1099-A, 1099-G, 1099-MISC, 1099-R, *1099-S,* 5498, 1042S, 6248, and 8027. To determine the number of returns you are required to file, or were required to file for the prior year, count each type of form separately. For example, if you must file 450 Forms 1098 and 100 Forms 1099-A, the 450 Forms 1098 must be filed on magnetic media; however, you are not required to file the 100 Forms 1099-A on magnetic media. THIS REQUIREMENT APPLIES SEPARATELY TO BOTH ORIGINAL AND CORRECTED RETURNS. For example, if you file 300 Forms 1099-MISC and later file 50 corrections for Forms 1099-MISC, only the original 300 returns would be required to be filed on magnetic media. The 50 1099-MISC corrections could be filed on paper since there are less than 250 corrections to be filed. All Forms 1099-B are required to be filed on magnetic media. For real estate transactions filed on *Form 1099-S, magnetic media filing is required if 250 or more returns must be filed.* Forms W-2 and W-2P are filed with the Social Security Administration (SSA), *NOT* with the Internal Revenue Service (IRS). These requirements shall not apply if you establish that it will cause you undue hardship. Refer to Part A, Sec. 3.

.03 CONTACT THE IRS NATIONAL COMPUTER CENTER (SEE PART A, SECTION 11 FOR THE ADDRESS) WITH QUESTIONS CONCERNING FORMS W-2 OR W-2P ONLY IF THE QUESTIONS PERTAIN TO AN EXTENSION OF TIME TO FILE OR MAGNETIC MEDIA WAIVER REQUESTS. QUESTIONS PERTAINING TO MAGNETIC MEDIA FILING OF FORMS W-2 OR W-2P SHOULD BE DIRECTED TO SSA. TAX LAW QUESTIONS PERTAINING TO FORMS W-2 OR W-2P SHOULD BE DIRECTED TO IRS TAXPAYER SERVICE.

.04 Personnel at the IRS National Computer Center are equipped to answer any questions you may have concerning the magnetic media filing of information returns (Forms 1098, 1099, 5498, W-2G, 1042S, 6248 and 8027). Tax law related questions should be directed to IRS Taxpayer Service.

.05 This procedure also provides the requirements and specifications for magnetic media filing under the Combined Federal/State Filing Program. Refer to Part A, Sec. 12.

.06 The following revenue procedures and publications provide more detailed filing procedures for certain information returns:

(a) 1988 "Instructions for Forms 1099, 1098, 5498, 1096, and W-2G," provide further information on filing returns with IRS. These instructions are available at IRS offices and are included in magnetic media reporting packages mailed to filers on this program each year.

(b) Rev. Proc. 84-33, 1984-1 C.B. 502, or other current revenue procedure, regarding the optional method for agents to report and deposit backup withholding.

(c) Publication 1179, Specifications for Paper Document Reporting and Paper Substitutes for Forms 1096, 1098, 1099 Series, 5498, and W-2G.

.07 This procedure supersedes the following revenue procedures: Rev. Proc. 87-62, 1987-2 C.B. 765, also published in Publication 1220 (Rev. 7-87), Requirements and Conditions for Filing Information Returns in the Forms 1098, 1099, 5498, and W-2G Series on Magnetic Tape and *Rev. Proc. 87-45, 1987-2 C.B. 591, also published in Publication 1311 (Rev. 8-87)*, Requirements and Conditions for Filing Information Returns in the Forms 1098, 1099, 5498 and W-2G Series on 5¼ inch magnetic diskette.

.08 Refer to Part A, Sec. 13 for definitions of terms used in this publication.

Section 2. Nature of Changes—Current Year (Tax Year 1988)

.01 Numerous editorial changes have been made to the publication *Changes made to the revenue procedure are italicized throughout this publication. IRS recommends however, that this revenue procedure be read in it's entirety to ensure proper reporting.* The following changes must be incorporated into your programs for tax year 1988.

.02 THE FOLLOWING CHANGES HAVE BEEN MADE TO PART A:

(a) Specifications for filing information returns on 5¼ inch and 3½ inch magnetic diskette have been included in this revenue procedure.

(b) Information returns can no longer be filed on Burroughs Mini Disk.

(c) Form 1099-S will be used to report real estate transactions. In the past, real estate transactions were reported on Form 1099-B. The instructions for reporting real estate transactions on Form 1099-S can be found in 1988 "Instructions for Forms 1099, 1098, 5498, 1096 and W-2G."

(d) Magnetic media must be used to submit ALL Forms 1099-B.

(e) Magnetic media filing is required if 250 or more Forms 1099-S are reported.

(f) Clarification on W-2 and W-2P processing was added. Forms W-2 and W-2P magnetic media related questions are handled by SSA. Tax law related questions on Forms W-2 and W-2P are handled by IRS Taxpayer Service. Only questions on undue hardship waivers and extensions of time to file Forms W-2 and W-2P are handled by IRS National Computer Center (see Part A, Section 11 for address).

(g) Form 4419 has been revised for 1988. When completing Form 4419, follow the instructions on the back of the form carefully.

(h) A hardcopy print is not an acceptable test file for the Combined Federal/State Program. Test files for the Combined Federal/State Program must be submitted on magnetic media between October 1 and December 15.

(i) If you are filing on two types of magnetic media, submit only one Form 4419. See Part A, Section 3.05.

(j) The specific types of returns for which a waiver is being requested must be specified on Form 8508.

(k) A separate Form 8508 must be submitted for each payer.

(l) Form 8508 must be filed by the payer *only*. See Part A, Section 3.08.

(m) If you, as an individual or organization, are an approved filer on magnetic media and you change the name or address of your organization, EIN, or person to contact specified on your original Form 4419, notify the IRS National Computer Center in writing.

(n) Magnetic media undue hardship waivers for Forms W-2 and W-2P must be filed at least 90 days prior to the due date of the return.

(o) Forms 4804 and 4802 have been revised for 1988. The revised forms must be used.

(p) When requesting an extension of time to file for multiple payers, the request must include a list of all payers, their TINS and addresses. See Part A, Section 6.01(h).

(q) Files which have been returned by IRS to the filer due to coding errors must be corrected and returned within 45 days from date of notice.

(r) Clarification was added to Part A, Section 9.02 concerning the validation of the SSN by using the Name Control.

(s) A payee statement may be perforated to a check for the account reported on the payee statement. See Part A, Section 10.02.

(t) The statement furnished to the payer for royalty payments need not be the official form. See Part A, Section 10.02.

(u) For Form 1098, the message appearing on the payee statement has changed. See Part A, Section 10.02(e).

(v) The message to appear on the payee statement for Form 1099-S was added to Part A, Section 10.02(f).

(w) The address of the IRS National Computer Center has changed. See Part A, Section 11 for new address.

(x) A computer generated Form 6847 may now be used. See Section 12.02.

(y) Forms 1099-S cannot be filed under the Combined Federal/State Filing Program.

(z) The Combined Federal State filing requirements for the state of Oregon have changed. The filing requirements are now the same as the federal filing requirements. See Part A, Section 12.11 table 2.

(aa) A definition of a foreign corporation has been added to Part A, Section 13.

(bb) The Foreign Country Code Table has been eliminated for 1988. See Part A, Section 14.02.

.03 THE FOLLOWING CHANGES HAVE BEEN MADE TO THE MAGNETIC MEDIA SPECIFICATIONS IN PART B:

(a) Part B, Section 1, 2 and 3 have undergone extensive changes, these sections should be reviewed carefully.

(b) Substantial changes have been made to Form 5064. See Part B, Section 1.02.

(c) Specifications for 5¼ inch and 3½ inch diskettes have been added.

(d) If diskettes are used and the operating system is not MS/DOS, the operating system and hardware information must be provided on Form 5064.

.04 THE FOLLOWING CHANGES HAVE BEEN MADE TO THE PAYER/TRANSMITTER "A" RECORD:

(a) Foreign corporations which are not required to have an EIN may leave the Payer's Federal EIN field in position 7-15 blank. Foreign corporations must set the Foreign Corporation Indicator in position 49 of the "A" Record to 1.

(b) Form 1099-S has been added to the Type of Return field.

(c) The Amount Indicators for Form 1098 have changed. Amount Indicator "2" has been deleted.

(d) Amount Code "1" on Form 1099-B which represented real estate transactions has been deleted.

(e) Amount Code "9" (low income housing credit) has been added to Form 1099-PATR.

(f) Form 1099-R has undergone substantial changes. Amount Code "1" now represents "Gross Distribution." Amount Code "2" represents "Taxable Amount." Amount Code "3" represents "Amount in Box 2 eligible for capital gain election." Amount Code "8" represents "Other." Amount Code "9" represents "State Income Tax Withheld." IRA and SEP payments are no longer reported in a separate field. They are reported in Amount Codes 1 and 2. Refer to 1988 "Instructions for Forms 1099, 1098, 1096, 5498 and W-2G" for detailed information.

(g) If a total distribution was made from an IRA during the year and no contributions were made for that year, you need not file Form 5498 to reflect that the fair market value on December 31 was zero.

(h) For Form 1099-S, Gross Proceeds are reported in Amount Code "2."

(i) The title of Amount Code "3" on Form 5498 for 1988 is "Life insurance cost included in Code 1."

.05 THE FOLLOWING CHANGES HAVE BEEN MADE TO THE PAYEE "B" RECORDS:

(a) An indicator was added to the Document Specific Code for Form 1098 to report mortgages incurred after 1987 for a purpose other than the purchase of a personal residence.

(b) The Document Specific Code was changed to reflect reporting the category of Total Distribution on Form 1099-R.

(c) For Form 1099-R, Percentage of Total Distribution is indicated in position 44-46 of the "B" Record.

(d) Positive or negative amounts can be reported using a "+" or "-" (minus sign) in the left most position of the Payment Amount fields. See the instructions for "Payment Amount Fields" of the "B" Records.

(e) A note was added in the Payee City field to clarify the reporting of foreign addresses.

(f) In the past, 30 blanks followed the Payee Zip Code field, this has been shortened to 28 positions.

(g) The format of all "B" records following the Payee Zip Code has changed. Refer to the individual field definitions following the Payee Zip Code field.

(h) The Description fields for Forms 1099-A, 1099-B, 1099-OID and 1099-S have been expanded to 39 positions.

(i) For Forms 1099-A, crops forfeited on Commodity Credit Corporation loans are indicated by placing "CCC" in the Description field in positions 378-416 of the "B" Record.

(j) For Forms 1099-B, the Date of Sale Indicator has been deleted. Brokers must now use the trade date.

(k) For Forms 1099-B, A Gross Proceeds Indicator has been added to the "B" Record in position 360. The Date of Sale Indicator has been eliminated, and Cusip number is now 13 positions.

(l) For Form 1099-S, if the transferor received or will receive property or services as part of the consideration for the property, this is indicated in the Property or Services received field (Position 418).

(m) For Forms 1099-S, Date of Closing is reported in positions 373-378. Property or Services Received is reported in position 418. Property Description is reported in positions 379-417.

.06 THE FOLLOWING CHANGES HAVE BEEN MADE TO THE STATE TOTALS "K" RECORDS:

(a) Clarification was added to specify how the Control Totals are reported in the "K" Records. See Section 8.04.

(b) The State Code is now reported in position 417-418 of the "K" Record.

.07 THE FOLLOWING CHANGE HAS BEEN MADE TO THE "F" RECORD:

(a) The Number of Reels is no longer indicated in position 6-8 of the "F" Record.

Section 3. Application for Magnetic Media Reporting and Requests for Undue Hardship Waivers

.01 For purposes of this revenue procedure, the PAYER includes the person making payments, a recipient of mortgage interest payments, a broker, a barter exchange, person reporting a real estate transaction, a trustee or issuer of an IRA or SEP, or a lender who acquires an interest in secured property or who has reason to know that the property has been abandoned. The TRANSMITTER is the organization submitting the magnetic media file. The payer and transmitter may be the same organization. Payers or their transmitters are required to complete Form 4419, Application for Filing Information Returns on Magnetic Media. *A single Form 4419 should be filed no matter how many types of returns the payer or transmitter will be submitting on magnetic media. For example, if you plan to file Forms 1099-INT and Forms 1099-DIV on magnetic media, submit one Form 4419.* If you later wish to file another type of return on magnetic media in the Form 1099, 1098, 5498, or W-2G, it is not necessary to submit a new Form 4419.

If you plan to file for multiple payers, IRS encourages filers to submit one application and to use one Transmitter Control Code for all payers. Include a list of all payers and their TINs with the Form 4419. If you file for additional payers in later years, you may simply notify IRS in writing providing the additional names and TINs. Do not submit a new application for these additional payers.

Copies of Form 4419, for your use, are included in this publication. *Form 4419 has been revised for 1988. When completing Form 4419, follow the instructions on the back of the form carefully.* Requests for additional information or forms related to magnetic media processing should be addressed to the IRS National Computer Center. The address is listed in Part A, Sec. 11.

.02 Application Form 4419 must be filed with the IRS National Computer Center before "test" files are submitted. ("Test" files must be submitted between October 1 and December 15 each year.) IRS will act on an application and notify the applicant, in writing, of authorization to file. A five character alpha/numeric Transmitter Control Code will be assigned and included in an acknowledgment letter. Magnetic media returns may not be filed with IRS until the application has been approved and a Transmitter Control Code assigned. Do not enter blanks in the "A" Record Transmitter Control Code field; enter the five character alpha/numeric Transmitter Control Code that is assigned to you by IRS.

.03 After you have received approval to file on magnetic media, you do not need to reapply each year; however, notify IRS in writing if:

(a) there are hardware or software changes that would affect the characteristics of the magnetic media submission (e.g., changing from 8-inch diskette to tape filing or vice versa, or reporting using more than one type of magnetic media), a new Transmitter Control Code may be necessary, or

(b) you discontinue filing on magnetic media for a year (your five character alpha/numeric Transmitter Control Code may be reassigned).

If either of these conditions apply to you, you should contact IRS for clarification. In ALL correspondence, refer to your current five character alpha/numeric Transmitter Control Code to assist IRS in locating your files.

.04 IRS will assist new filers with their initial magnetic media submission by reviewing "test" files submitted in advance of the filing season. The "test" data should be actual data for the "A" Records, not fictitious information. Approved payers or transmitters should submit "test" files to the IRS National Computer Center. *In order to participate in the Combined Federal/State Program, you MUST submit a magnetic media "test" file. This test file is only required for the first year that you participate in the Combined Federal/State Program. ALL new filers, however, are encouraged to submit "test" files.* All "test" files must be submitted between October 1 and December 15 each year. Refer to Part A, Sec. 11 for the address. Do not submit "test" files after December 15. If you are unable to submit your magnetic media "test" file by this date, you may only send a sample hardcopy printout that shows a sample of each type of record (A, B, C, and F) used to the IRS National Computer Center. *This sample hardcopy printout must be postmarked by January 15, 1989. A hardcopy print is not an acceptable test file for the Combined Federal/State Program. Combined Federal/State test files must be submitted on magnetic media between October 1 and December 15.* Clearly mark the hardcopy printout as "TEST DATA," and include identifying information such as name, address, and telephone number of someone familiar with the "test" print who may be contacted to discuss its acceptability. With all "test" data, include a transmittal Form 4804, 4802 or computer generated substitute marked as "TEST DATA" that identifies your five character alpha/numeric Transmitter Control Code, total record and money amounts. *The transmittal Form 4804 and 4802 were updated for tax year 1988.* Agencies who produce a computer generated substitute must include the additional information required on these forms. The Form 4804 includes a checkbox 1 to indicate the type of file (e.g., original, correction, replacement, test). The "test" data must be coded according to the current revenue procedure.

.05 If your magnetic media files have been prepared for you in the past by a service agency, and you now have computer equipment compatible with that of IRS and wish to prepare your own files, you must request your own five character alpha/numeric Transmitter Control Code by filing an application, Form 4419, as described above. *If you should happen to file on two types of magnetic media (e.g., tape and 8 inch diskette), only one Form 4419 should be submitted.* IRS will assign different Transmitter Control Codes to each type of magnetic media. This ensures that IRS will provide the proper revenue procedure to filers each year.

.06 *If you as an individual or organization are an approved filer on magnetic media and you change the name or address of the organization, person to contact or EIN specified on your original Form 4419, please notify the IRS National Computer Center, in writing, so that your file may be updated to reflect the correct information.*

.07 In accordance with section 1.6041-7(b) of the Income Tax Regulations, payments to providers of medical and health care services from separate departments of a health care carrier may be reported as separate returns on magnetic media. In this case, the headquarters office will be considered to be the transmitter, and the individual departments of the company filing reports will be considered to be payers. A single application form covering all the departments that will be filing on magnetic media should be submitted. One five character alpha/numeric Transmitter Control Code may be used for all departments.

.08 Any person required to file original or corrected returns on magnetic media may request a waiver from the filing requirements by submitting Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media, with the IRS National Computer Center if filing on magnetic media would create an undue hardship. *A SEPARATE FORM 8508 MUST BE SUBMITTED FOR EACH PAYER.* It is not acceptable to submit a list of payers. *The specific types of returns for which a waiver is being requested must be specified on Form 8508 (e.g., 1099-DIV, 1099-MISC). Persons or organizations who serve as transmitters only cannot submit Form 8508 for persons required to file on magnetic media. Form 8508 must be filed by the payer only.* For returns required to be filed on magnetic media, waiver requests must be filed at least 90 days before the returns are due. This waiver, if approved, will only provide exemption from magnetic media filing for one tax year. Filers cannot apply for a waiver for more than one tax year at a time. You must reapply each year that a waiver is necessary. Copies of Form 8508 are included in this publication and may be obtained from the IRS National Computer Center and other IRS offices. See Part A, Sec. 11 for the address of the IRS National Computer Center.

.09 Section 1.6045-1(l) of the Income Tax Regulations requires brokers and barter exchanges to use magnetic media in reporting to IRS ALL Form 1099-B data. THIS REQUIREMENT APPLIES SEPARATELY TO BOTH ORIGINAL AND CORRECTED RETURNS. Generally NEW brokers and NEW barter exchanges may request an undue hardship exemption by filing a request for waiver *on Form 8508* with the IRS National Computer Center by the end of the second month following the month in which they became a broker or barter exchange.

.10 *All* requests for magnetic media related undue hardship exemptions must be submitted to the IRS National Computer Center at least 90 days before the due date of the return except as stated in Part A, Sec. 3.09. All magnetic media related undue hardship requests for Forms W-2 and W-2P are to be filed with the IRS National Computer Center, not SSA. Refer to Part A, Sec. 11 for the address.

.11 If you request a waiver from filing on magnetic media and it *is* approved, DO NOT SEND A COPY OF THE APPROVED WAIVER TO THE SERVICE CENTER WHERE YOU FILE YOUR PAPER RETURNS. Keep the waiver for your records. Do NOT staple, paperclip or use rubberbands on any scannable forms. Paper information returns are read by an optical scanner (OCR) at the service centers.

.12 Waivers are granted on a case-by-case basis and may be approved at the discretion of the IRS National Computer Center.

.13 If you are required to file on magnetic media but fail to do so and you do not have an approved waiver on record, you may be subject to a failure to file penalty. Refer to Part A, Sec. 4.01.

.14 An approved waiver from filing information returns on magnetic media does not provide exemption from filing; you MUST still file your information returns on acceptable paper forms.

.15 A magnetic media reporting package, which includes all the necessary transmittals, labels, and instructions, will be mailed to the last known address of all approved filers each year.

Section 4. Filing of Magnetic Media Reports and Retention Requirements

.01 If you do not file your returns on time, you may be subject to a $50 per return failure to file penalty. If you file without following the instructions in this revenue procedure, you may also be subject to a $50 per return failure to file penalty. The maximum penalty is $100,000 per calendar year. However, there is no maximum penalty for Forms 1099-INT, 1099-OID, 1099-DIV, 1099-PATR, 5498, or if the failure to file is due to intentional disregard of the filing requirements.

.02 Generally, you are subject to a $50 penalty for *each* failure to include the payee's correct TIN on an information return *unless the failure is due to reasonable cause or in some cases the payer can demonstrate that the payer met the due diligence requirements.* Refer to Part A, Sec. 9. For the definition of Payer and Payee see Part A, Sec. 13.

.03 Form 4804, Transmittal of Information Returns Reported on Magnetic Media, must accompany magnetic media submissions. If you file for multiple payers and have the authority to sign the affidavit on Form 4804, you should also submit Form 4802, Transmittal for Multiple Magnetic Media Reporting. *Forms 4804 and 4802 have been revised for tax year 1988. The revised forms must be used for your tax year 1988 submissions.* Be sure to include Form 4804, 4802 or computer generated substitute with your magnetic media shipment. DO NOT MAIL THE MAGNETIC MEDIA AND THE TRANSMITTAL DOCUMENTS SEPARATELY. *Magnetic media files covered by this revenue procedure are to be sent to the IRS National Computer Center (see Part A, Section 11 for the address).* IRS encourages the use of a computer generated Form 4804 that includes all necessary information requested on the current form.

Paper information returns must be transmitted to the appropriate service center using Form 1096, Annual Summary and Transmittal of U.S. Information Returns. Do not send information returns filed on paper forms to the IRS National Computer Center.

.04 The affidavit for Form 4804 should be signed by the payer; however, the transmitter, service bureau, paying agent, or disbursing agent (all hereafter referred to as agent), may sign the affidavit on behalf of the payer if the conditions in (a), (b)(i) or (b)(ii), and (c) are met:

(a) The agent has the authority to sign the affidavit under an agency agreement (either oral, written, or implied) that is valid under state law.

(b)(i) The agent has the responsibility (either oral, written or implied) conferred on it by the payer to request the TINs of payees (or others for whom information is being reported),

OR

(ii) If the return of more than one payer is included in a single magnetic media submission, covered by a single Form 4804, each payer has attested by affidavit to the agent that the payer has complied with the law in attempting to secure correct TINs.

(c) The agent signs the affidavit and adds the caption "For: (name of payer)."

.05 Although a duly authorized agent signs the affidavit, the payer is held responsible for the accuracy of the Form 4804, and the payer will be liable for penalties for failure to comply with filing requirements.

.06 DO NOT REPORT THE SAME INFORMATION ON PAPER FORMS THAT YOU REPORT ON MAGNETIC MEDIA. IF YOU REPORT PART OF YOUR RETURNS ON PAPER AND PART ON MAGNETIC MEDIA, BE SURE THAT DUPLICATE RETURNS, WITH THE SAME INFORMATION, ARE NOT INCLUDED ON BOTH. This does not mean that corrected documents are not to be filed. If a return has been prepared and submitted improperly, you must file a corrected return as soon as possible. Refer to Part A, Sec. 8 for requirements and instructions on filing corrected returns.

.07 Reports from different branches or locations for one payer, if submitted on the same file, MUST be consolidated under one Payer/Transmitter "A" Record for each type of information return. For example, all Forms 1099-INT for the same payer on a single file must be sorted together under one Payer/Transmitter "A" Record followed by the appropriate "B" Records and one "C" Record.

.08 Before submitting magnetic media files, include the following:

(a) A signed Form 4804 or computer generated substitute.

(b) A Form 4802 if you transmit for multiple payers and have the authority to sign the affidavit on Form 4804.

(c) The magnetic media with an external identifying label as described in Part B, Section 1. Be sure to include the proper sequence on this label.

(d) On the outside of the shipping container, include a Form 4801 or a substitute for the form which reads "DELIVER UNOPENED TO TAPE LIBRARY–MAGNETIC MEDIA REPORTING–BOX ____ of ____." If there is only one container, mark the outside as Box *1* of *1*. For multiple containers, include the sequence (e.g., Box 1 of 33, 2 of 33, etc.).

(e) If you were granted an extension, include a copy of the approval letter with the magnetic media shipment. *See Part A, Section 6.01 for information on how to apply for an extension of time to file.*

.09 IRS will not pay or accept "Collect on Delivery" or "Charged to IRS" shipments of reportable tax information that an individual or organization is legally required to submit.

.10 Files may be returned to you due to coding or format errors. These are to be corrected and returned to IRS within 45 days of date of notice or the payer may be subject to a failure to file penalty. If you are unable to return the file within 45 days, request an extension of time.

.11 Payers are required to retain a copy of the information returns filed with IRS or to have the ability to reconstruct the data for at least three years.

Section 5. Filing Dates

.01 The dates prescribed for filing paper returns with IRS also apply to magnetic media filing. Magnetic media reporting to IRS for Forms 1098, 1099, and W-2G must be on a calendar year basis. Form 5498 is used to report amounts contributed during or after the calendar year but not later than April 17.

.02 Information returns filed on magnetic media for Forms 1098, all types of Forms 1099, and W–2G must be submitted to IRS and postmarked by February 28 but not before January 1. The due date for furnishing the required copy or statement to the payee is January 31.

.03 Information returns filed on magnetic media for Form 5498 must be submitted to IRS and postmarked by May 31. Trustees or issuers of IRAs or SEPs must provide participants with a statement of the value of the participant's account by January 31, in any written format. Statements are due to the participants by May 31 for contributions made to IRAs for the prior calendar year. Form 5498 is filed for contributions to be applied to 1988 that are made between January 1, 1988, and April 17, 1989.

Section 6. Extensions of Time to File

.01 *If a payer or transmitter of information returns on magnetic media or paper forms filed with IRS or SSA is unable to submit their magnetic me-*

dia or paper file by the dates prescribed in Sec. 5.02 and 5.03 above, submit a letter requesting an extension of time for a maximum of 60 days as soon as you are aware that an extension will be necessary. In order to be considered, the request MUST be filed before the due date of the return; otherwise, you will be subject to the late filing penalty of $50 per return. The letter should be sent to the attention of the Magnetic Media Reporting Program at the IRS National Computer Center. See Part A, Sec. 11 for the address. The request should include:

(a) The filer's (or transmitter's, if filing for multiple payers) name and address.

(b) The filer's Taxpayer Identification Number (SSN or EIN).

(c) The tax year for which the extension of time is requested: tax year 1988.

(d) The name and telephone number of a person to contact who is familiar with the request.

(e) The specific type of returns and expected volume (e.g., 5000 Forms 1099–INT).

(f) The five character alpha/numeric Transmitter Control Code assigned to the organization or individual requesting the extension (if a number has been assigned).

(g) The reason for the delay and date that you will be able to file.

(h) If you file for multiple payers, the request must include a list of all payers, their TINs (SSN or EIN), *and addresses.*

An approved extension for magnetic media filing does not provide additional time for supplying a copy to the payee. If additional time is needed in providing a copy to the payee, contact the District Director of the IRS District in which you reside or in which your business is located.

.02 If an extension of time to file on magnetic media is granted by the IRS National Computer Center, a copy of the letter granting the extension MUST be included with the transmittal Form 1096, 4804 or computer generated substitute when the file is submitted.

Section 7. Processing of Magnetic Media Returns

.01 All data received at the IRS National Computer Center for processing will be given the same protection as individual returns (Form 1040), and will be returned to the originator after processing. Please open all returned files as soon as you receive them. In some cases, files are returned due to errors and they must be corrected and returned to IRS within 45 days of date of notice or you may be subject to a failure to file penalty.

.02 Due to the volume of input received and the cost to return special containers, special shipping containers should not be used for transmitting data to the IRS National Computer Center since IRS *will not return* such containers.

.03 Files will be returned to you for correction if they are unprocessable due to format or coding errors, or by the request of the filer. Unprocessable files must be corrected and returned to the IRS National Computer Center within 45 days of date of notice or the payer may be subject to a failure to file penalty. The corrected files will be returned to the filer by the IRS National Computer Center after processing. PLEASE BE SURE THAT YOUR FORMAT AND CODING COMPLY WITH THIS REVENUE PROCEDURE. THIS REVENUE PROCEDURE IS TO BE USED FOR THE PREPARATION OF TAX YEAR 1988 INFORMATION RETURNS ONLY. LEGISLATIVE AND FORMS CHANGES AFFECTING INFORMATION RETURNS MAY OCCUR EACH YEAR. THESE PROCEDURES ARE UPDATED TO REFLECT NECESSARY CHANGES. PLEASE READ THIS PUBLICATION CAREFULLY.

Section 8. How to File Corrected Returns

.01 The filing requirement thresholds listed in Part A, Sec. 1 apply separately to both original and corrected returns. A hardship waiver is only required for corrected returns if the total number of corrections for a particular tax year exceeds the magnetic media threshold. For example, if 100 corrections for Form 1099–A are filed, they may be submitted on paper forms and no waiver is required; however, if 300 corrected Forms 1099–A are to be filed on paper, a waiver is required. Corrections should be aggregated and filed as soon as possible but not later than October 1 of each year. ALL FIELDS MUST BE COMPLETED WITH THE CORRECT INFORMATION, NOT JUST THE DATA FIELDS NEEDING CORRECTION. Submit corrections only for the returns filed in error, not the entire file. If your complete file is in error, contact the IRS National Computer Center immediately. If you file corrected returns on paper forms, submit Copy A to the appropriate service center. There are numerous types of errors. It may require more than one transaction to properly correct the initial error. A "G" in magnetic media position 7 of the "B" Record is used to indicate a corrected return. You are strongly encouraged to read this ENTIRE section before attempting to make ANY correction (if the initial return was filed as an aggregate, you must consider this in filing the corrected return).

.02 Corrected returns submitted to IRS on magnetic media, using a "G" coded Payee "B" Record, may be submitted on the same media as those corrections submitted without the "G" code; however, they must be submitted using a separate "A" Record. Corrected returns are to be identified as corrections on the transmittal document, by marking the appropriate checkbox, and on the EXTERNAL affixed label of the file.

.03 The instructions that follow will provide information on how to file corrected returns on magnetic media. The 1988 "Instructions for Forms 1099, 1098, 5498, 1096, and W-2G" provide more specific instructions for filing corrections on paper forms and are included in your magnetic media reporting packages each year.

.04 If you are not required to file your corrections on magnetic media and you file them on paper forms, do not submit the paper returns to the IRS National Computer Center. All paper returns, whether original or corrected, must be filed with the appropriate service center. Corrected returns filed on magnetic media must be filed with the IRS National Computer Center. Refer to Part A, Sec. 11 for the address.

.05 Statements to payees should be identified as "CORRECTED" and should be provided to them as soon as possible.

.06 Use the same name and TIN (SSN or EIN) for the payee on the Form 4804 transmittal and all related "A" Records.

.07 A transmittal Form 4804 or computer generated substitute is used to transmit magnetic media. A Form 4802 is a continuation form for a Form 4804. Please utilize a Form 4802 if you file on magnetic media for multiple payers and are an authorized agent for the payers.

.08 Use the correct tax year's revenue procedures to file information returns with IRS (i.e., do not submit tax year 1988 returns using the 1987 format). You must submit your returns filed on magnetic media using the revenue procedure for the tax year of the returns. Forms and revenue procedures are normally updated each year to include necessary legislative and forms changes.

.09 On magnetic media files, the Payee "B" Record provides space to enter a Payer's Account Number for the Payee. This same account number may be provided on paper forms. In order to properly file corrected returns, this number will help identify the appropriate incorrect return if more than one return was filed for a particular payee. DO NOT ENTER A TIN (SSN OR EIN). A PAYER'S ACCOUNT NUMBER FOR THE PAYEE MAY BE A CHECKING ACCOUNT NUMBER, SAVINGS ACCOUNT NUMBER, SERIAL NUMBER OR ANY OTHER NUMBER ASSIGNED TO THE PAYEE BY THE PAYER THAT WILL DISTINGUISH THE SPECIFIC ACCOUNT. THIS NUMBER MUST APPEAR ON THE INITIAL RETURN AND ON THE CORRECTED RETURN IN ORDER TO IDENTIFY AND PROCESS THE CORRECTION PROPERLY.

.10 REVIEW THE CHART THAT FOLLOWS. The types of errors made will normally fall under one of the three categories listed. Next to each type of error made, you will find a list of instructions to tell you how to properly file the corrected return for that type of error. READ ALL OF THE INSTRUCTIONS LISTED AND FOLLOW THEM FOR THE TYPE OF ERROR MADE ON THE INITIAL RETURN. IN SOME CASES TWO TRANSACTIONS ARE REQUIRED TO PROPERLY FILE CORRECTIONS. IF THE ORIGINAL RETURN WAS FILED AS AN AGGREGATE, YOU MUST CONSIDER THIS IN FILING CORRECTED RETURNS.

Guidelines for Filing Corrected Returns On Magnetic Media

(PLEASE READ SEC. 8.01 THROUGH 8.10 OF THIS PUBLICATION BEFORE MAKING *ANY* CORRECTIONS)

Error Made on the Original Return Filed on Magnetic Media	How To File the Corrected Return on Magnetic Media
1. Original return was filed with NO Payee TIN (SSN or EIN), OR the return was filed with an INCORRECT Payee TIN. THIS WILL REQUIRE TWO SEPARATE TRANSACTIONS TO MAKE THE CORRECTION PROPERLY. READ AND FOLLOW ALL INSTRUCTIONS FOR BOTH TRANSACTIONS 1 AND 2.	TRANSACTION 1: Identify return submitted with NO TIN or an INCORRECT TIN A. Form 4804 and/or 4802 (or computer substitute) 1. Prepare a new transmittal Form 4804 (and 4802 if you file for multiple payers), or a computer generated substitute, that includes information related to this new file. 2. Mark the Correction box in Block 1 of the current copy of Form 4804. If you submit a computer generated substitute for Form 4804, indicate "MAGNETIC MEDIA CORRECTION" at the top of the listing. 3. Provide ALL requested information correctly. 4. If you are a Combined Federal/State filer, IRS will not transmit corrected returns to the state. This will be the responsibility of the filer. Do not include "K" Records in your corrected returns. B. Form 1098, 1099, 5498 or W-2G 1. Prepare a new file. 2. Use a separate Payer/Transmitter "A" Record for each type of return being reported. The information in the "A" Record will be the same as it was in the original submission. 3. The Payee "B" Record must contain exactly the same information as submitted previously EXCEPT; insert a "G" in media position 7 of the "B" Record AND for ALL payment amounts used, enter "0" (zero). 4. Corrected returns submitted to IRS using a "G" coded "B" Record may be submitted on the same tape or diskette as those returns submitted without the "G" code; however, separate "A" Records are required. 5. Mark the EXTERNAL label of the tape or diskette "MAGNETIC MEDIA CORRECTION." 6. Submit the magnetic media and the transmittal document(s) to the IRS National Computer Center. (Refer to Part A, Sec. 11 for the address.) TRANSACTION 2: Reporting the correct information. A. Form 4804 and/or 4802 (or computer generated substitute). 1. If you submitted records with the corrected information on a separate tape or diskette from those that are "G" coded, prepare a new Transmittal Form 4804 (and 4802 if you file for multiple payers), or a computer generated substitute, that includes information related to this new file. 2. Mark the Correction box in Block 1 of the current copy of Form 4804. If you submit a computer generated substitute for Form 4804, indicate "MAGNETIC MEDIA CORRECTION" at the top of the listing.

Guidelines for Filing Corrected Returns On Magnetic Media

(PLEASE READ SEC. 8.01 THROUGH 8.10 OF THIS PUBLICATION BEFORE MAKING *ANY* CORRECTIONS)

Error Made on the Original Return Filed on Magnetic Media	How To File the Corrected Return on Magnetic Media
	3. Provide ALL requested information correctly. 4. If you are a Combined Federal/State filer, IRS will not transmit corrected returns to the state. This will be the responsibility of the filer. Do not include "K" Records in your corrected returns. B. Forms 1098, 1099, 5498 or W-2G 1. Prepare a new file with the correct information in ALL records. 2. Use a separate Payer/Transmitter "A" Record for each type of return being reported. 3. Do not code the Payee "B" Record as a corrected return for this type of correction. 4. Submit the new returns as though they were originals. Provide all of the correct information including the TIN (SSN or EIN). 5. Mark the EXTERNAL label of the tape or diskette "MAGNETIC MEDIA CORRECTION." 6. Submit the magnetic media and the transmittal document(s) to the IRS National Computer Center. (Refer to Part A, Sec. 11 for the address.)
2. Original return was filed with an incorrect money amount(s) in the Payee "B" Record, OR a money amount was reported using an incorrect Payment Amount Indicator in the original Payer/Transmitter "A" Record. Correct Type Of Return indicator was used in the "A" Record. (NOTE: If the wrong Type Of Return indicator was used, see Number 3 of this chart.)	A. Form 4804 and 4802 (or computer generated substitute) 1. Prepare a new transmittal Form 4804 (and 4802 if you file for multiple payers), or a computer generated substitute, that includes information related to this new file. 2. Mark the Correction box in Block 1 of the current copy of Form 4804. If you submit a computer generated substitute for Form 4804, indicate "MAGNETIC MEDIA CORRECTION" at the top of the listing. 3. Provide ALL requested information correctly. 4. If you are a Combined Federal/State filer, IRS will not transmit corrected returns to the state. This will be the responsibility of the filer. Do not include "K" Records in your corrected returns. B. Forms 1098, 1099, 5498 or W-2G 1. Prepare a new file. 2. Use a separate Payer/Transmitter "A" Record for each type of return being reported. The information in the "A" Record will be the same as it was in the original submission EXCEPT, the correct Amount Indicators will be used. 3. The Payee "B" Record must contain exactly the same information as submitted previously EXCEPT: insert a "G" in tape or diskette position 7 of the "B" Record AND report the correct payment amounts as they should have been reported on the initial return. 4. Corrected returns submitted to IRS using a "G" coded "B" Record may be submitted on the same tape or diskette as those returns submitted without the "G" code; however, separate "A" Records are required. 5. Mark the EXTERNAL label of the tape "MAGNETIC MEDIA CORRECTION." 6. Submit the magnetic media and the transmittal document(s) to the IRS National Computer Center. (Refer to Part A, Sec. 11 for the address.)
3. Original return was filed using the WRONG Type of Return indicator in the Payer/Transmitter "A" Record. For example, a return was coded using the Type of Return indicator for 1099-DIV and it should have been coded for 1099-INT. THIS WILL REQUIRE TWO SEPARATE TRANSACTIONS TO MAKE THE CORRECTION PROPERLY. READ AND FOLLOW ALL INSTRUCTIONS FOR BOTH TRANSACTIONS 1 AND 2.	TRANSACTION 1: Identify return submitted with an incorrect Type Of Return indicator A. Form 4804 and 4802 (or computer generated substitute) 1. Prepare a new transmittal Form 4804 (and 4802 if you file for multiple payers), or a computer generated substitute, that includes information related to this new file. 2. Mark the Correction box in Block 1 of the current copy of Form 4804. If you submit a computer generated substitute for Form 4804, indicate "MAGNETIC MEDIA CORRECTION" at the top of the listing.

Guidelines for Filing Corrected Returns On Magnetic Media

(PLEASE READ SEC. 8.01 THROUGH 8.10 OF THIS PUBLICATION BEFORE MAKING *ANY* CORRECTIONS)

Error Made on the Original Return Filed on Magnetic Media	How To File the Corrected Return on Magnetic Media

3. **Provide ALL requested information correctly.**
4. **If you are a Combined Federal/State filer, IRS will not transmit corrected returns to the state. This will be the responsibility of the filer. Do not include "K" Records in your corrected returns.**

B. Forms 1098, 1099, 5498 or W-2G

1. **Use a separate Payer/Transmitter "A" Record for each type of return being reported. The information in the "A" Record will be exactly the same as it was in the original submission using the same incorrect type of return indicator.**
2. **The corrected Payee "B" Record must contain the same information as submitted previously EXCEPT: insert a "G" in tape or diskette position 7 of the "B" Record and for ALL payment amounts used, enter "0" (zero).**
3. **Corrected returns submitted to IRS using a "G" coded "B" Record may be submitted on the same tape or diskette as those returns submitted without the "G" code; however, separate "A" Records are required.**
4. **Mark the EXTERNAL label of the tape "MAGNETIC MEDIA CORRECTION."**
5. **Submit the magnetic media and the transmittal document(s) to the IRS National Computer Center. (Refer to Part A, Sec. 11 for the address.)**

TRANSACTION 2: Report correct information

A. Form 4804 and 4802 (or computer generated substitute)

1. **If you submit records with the corrected information on a separate tape or diskette from those that are "G" coded, prepare a new transmittal Form 4804 (and 4802 if you file for multiple payers), or a computer generated substitute, that includes information related to this new file.**
2. **Mark the Correction box in Block 1 of the current copy of Form 4804. If you submit a computer generated substitute for Form 4804, indicate "MAGNETIC MEDIA CORRECTION" at the top of the listing.**
3. Provide ALL requested information correctly.
4. If you are a Combined Federal/State filer, IRS will not transmit corrected returns to the state. This will be the responsibility of the filer. Do not include "K" Records in your corrected returns.

B. Forms 1098, 1099, 5498 or W-2G

1. Prepare a new file with the correct information in ALL records.
2. Use a separate Payer/Transmitter "A" Record for each type of return being reported and use the correct Type Of Return indicator.
3. Do not code the Payee "B" Record as a corrected return for this type of correction.
4. Provide all of the correct information.
5. Mark the EXTERNAL label of the tape "MAGNETIC MEDIA CORRECTION."
6. Submit the magnetic media and the transmittal document(s) to the IRS National Computer Center. (Refer to Part A, Sec. 11 for the address.)

Section 9. Taxpayer Identification Numbers

.01 Section 6109 of the Internal Revenue Code, *and the regulations thereunder, requires a person whose Taxpayer Identification Number (TIN) must be shown on an information return to furnish his or her TINs to the person required to file the information return.* The number must be furnished to the payer whether or not the payee is required to file a tax return or is covered by social security. Refer to Part A, Sec. 13 for a definition of taxpayer identification number (TIN).

.02 The recipient's TIN is used to associate and verify amounts reported to IRS with corresponding amounts on tax returns. Therefore, it is particularly important that correct social security and employer identification numbers for payees be provided on magnetic media or paper forms submitted to IRS. *IRS validates the SSN by using the Name Control of the surname of the individual who has been assigned this number. For this reason, provide the surname in the First Payee Name Line and/or the Name Control in positions 8-11 of the "B" Record. Failure to provide this information may make it impossible for IRS to validate the SSN.* DO NOT ENTER HYPHENS, ALPHA CHARACTERS, ALL 9s OR ALL ZEROS.

.03 Under section 6676 of the Internal Revenue Code, a $50 penalty applies for each failure to furnish a TIN to another person who is required to file an information return, and for each failure to include a TIN on an information return. *Except for interest and dividends, the penalty applies unless the failure to comply is due to reasonable cause and not willful neglect. The maximum penalty for other than interest and dividends is $100,000 for each failure to furnish the recipients TIN on an information return.* For mortgages in existence before 1985, you will not be subject to the penalty for failure to provide the TIN of the payer of record on Form 1098 if you followed the rules for requesting TINs contained in Temporary Regulations section 1.6050H-1T, and you properly and promptly processed the responses.

.04 With respect to all payers of interest and dividends, section 6676 of the Internal Revenue Code provides that the payer must self-assess a $50 penalty for each failure to include a payee's TIN or each inclusion of an incorrect TIN on an information return, unless the payer can demonstrate that the payer met the due diligence requirements in attempting to acquire correct TINs for payees. Use Form 8210, Self-Assessed Penalties Return.

A penalty of $5 per failure applies to each failure by a payer to include his or her own TIN in any return, statement, or document.

.05 For certain reportable payments, if the payee fails to provide a TIN to the payer in the manner required, then backup withholding must be instituted for that payee. If the payee has applied for a TIN, the payee may certify to this on Form W-9 by noting "Applied For" in the TIN block and by signing the form. This form then becomes an "awaiting-TIN certificate." If the TIN is not received and certified, if required, within 60 days, begin withholding and continue until you receive a TIN in the manner required. If IRS notifies the payer that the payee's TIN is incorrect, the payee has 30 days to provide a TIN to the payer in the manner required or backup withholding must be instituted.

.06 The TIN to be furnished to IRS depends primarily upon the manner in which the account is maintained or set up on the payer's record. The payer and payee names and TINs should be consistent with the names and numbers used on other tax returns. The name and TIN must be those of the owner of the account. If the account is recorded in more than one name, furnish the TIN and name of one of the owners of the account. The TIN provided must be associated with the name of the payee provided in the first name line of the Payee "B" Record. For individuals, including sole proprietors, the payee TIN is the payee's social security number. For other entities, the payee TIN is the payee's employer identification number.

.07 Sole proprietors who are payers should show their employer identification number in the Payer/Transmitter "A" Record. However, sole proprietors who are not otherwise required to have an employer identification number should use their social security number.

.08 The charts below will help you determine the TIN to be furnished to IRS for *those persons for whom you are reporting information (payees).*

CHART 1. Guidelines for Social Security Numbers

For this type of account—	In the Taxpayer Identification Number field of the Payee "B" Record, enter the SSN of—	In the First Payee Name Line of the Payee "B" Record, enter the name of—
1. Individual.	The individual.	The individual.
2. Joint account (Two or more individuals, including husband and wife).	The actual owner of the account. (If more than one owner, the first individual on the account.)	The individual whose SSN is entered.
3. Account in the name of a guardian or committee for a designated ward, minor, or incompetent person.	The ward, minor, or incompetent person.	The individual whose SSN is entered.
4. Custodian account of a minor (Uniform Gift to Minors Act).	The minor.	The minor.
5. The usual revocable savings trust account (grantor is also trustee).	The grantor trustee.	The grantor-trustee.
6. A so-called trust account that is not a legal or valid trust under state law.	The actual owner.	The actual owner.
7. A sole proprietorship.	The owner.	The owner.

CHART 2. Guidelines for Employer Identification Numbers

For this account type—	In the Taxpayer Identification Number field of the Payee "B" Record, enter the EIN of—	In the First Payee Name Line of the Payee "B" Record, enter the name of—
1. A valid trust, estate, or pension trust.	Legal entity.[1]	The legal trust, estate, or pension trust.
2. Corporate.	The corporation.	The corporation.
3. Association, club, religious, charitable, educational or other tax-exempt organization.	The organization.	The organization.
4. Partnership account held in the name of the business.	The partnership.	The partnership.
5. A broker or registered nominee/middleman.	The broker or nominee/middleman.	The broker or nominee/middleman.
6. Account with the Department of Agriculture in the name of a public entity, such as a state or local government, school district, or prison, that receives agriculture program payments.	The public entity.	The public entity.

---

[1] Do not furnish the identification number of the personal representative or trustee unless the name of the representative or trustee is used in the account title.

Section 10. Effect on Paper Returns

.01 Magnetic media reporting of the information returns listed in Part A, Sec. 1 applies only to the original (Copy A).

.02 For payments of dividends or interest (reported on Forms 1099-DIV, 1099-PATR, 1099-INT or 1099-OID) the payer is required to furnish an official Form 1099 to a payee in person or in a "statement mailing" by first-class mail. *For payments of royalties, a statement in person or in a statement mailing is also required, but the statement need not be the official form.* These forms may not be combined or mailed with other information furnished to the recipient except Forms W-2, W-2P, W-8, W-9, other Forms 1098, 1099, 5498, a check, a letter explaining why no check is enclosed, a letter limited to an explanation of the tax consequences of the information shown on the payee statement, *and a statement of the person's account reflected on the 1099.* The outside of the envelope and each check, letter, or account statement must contain the legend, "Important Tax Return Document Enclosed." *A payee statement may be perforated to a check with respect to the account reported on the payee statement or to a statement of the payee's specific account if payments on such account are reflected in the payee's statement. The enclosure to which the payee statement is perforated must contain the legend "Important Tax Return Document Attached."* No additional enclosures, such as advertising, promotional material, or a quarterly or annual report, are permitted. The payer may use substitute Forms 1099 if they utilize the proper language, are substantially similar to the official forms, and the payer complies with all revenue procedures relating to substitute Forms 1099 in effect at the time (see Publication 1179). The substitute payee statement must contain instructions substantially similar to those on the back of Copy B of the official form. The following messages must appear on the payee statements:

(a) Forms 5498 and 1099-R–"This information is being furnished to the Internal Revenue Service."

(b) Forms 1099-G and W-2G–"This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and IRS determines that it has not been reported."

(c) Forms 1099-B and 1099-MISC–Same as item (b) above, except change "may" to "will" in the second sentence.

(d) Form 1099-A–"This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported."

(e) Form 1098–(1)–*"This is important tax information and is being furnished to the Internal Revenue Service."* If you are required to file a return, a negligence penalty or other sanction will be imposed on you if the IRS determines that an underpayment of tax results because you *overstated a deduction for this mortgage interest* on your return. (2) "The amount shown may not be fully deductible by you on your Federal income tax return. Limitations based on the cost and value of the secured property may apply. *In addition, you may only deduct an amount of mortgage interest to the extent it was incurred by you, actually paid by you, and not reimbursed by another person."*

(f) *Forms 1099-S–"This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this item is required to be reported and the IRS determines that it has not been reported."*

.03 Statements to recipients for Forms 1098, 1099-A, 1099-B, 1099-G, 1099-MISC (except for substitute payments in lieu of dividends and tax-exempt interest), 1099-R, 1099-S, 5498, or W-2G need not be a copy of the paper form filed with IRS. However, it is important that income items be properly classified for Federal tax purposes on the statement the payer gives to recipients. The space provisions on official paper forms do not agree with those used in magnetic media. The amount of space on paper forms is less than that allowed on magnetic media. Filers may wish to seek a substitute form for statements to payees that accommodates the space provisions used in magnetic media. Payers are permitted considerable flexibility in designing statements to payees. The payer may combine the information return data with other reports or statements as long as all required information is present and worded properly and the payee's copy is conducive to proper reporting of income on tax returns. (This does not apply to Forms 1099-INT, 1099-OID, 1099-DIV and 1099-PATR. See Part A, Sec. 10.02 above for the requirements for these four forms.)

Section 11. How to Contact the IRS National Computer Center

.01 Magnetic media processing for all service centers is centralized at the IRS National Computer Center. *Magnetic media covered under this revenue procedure and all requests for IRS magnetic media related publications, information, undue hardship waivers, extensions of time or forms are to be directed to the following addresses* (if Postal Service or land carrier):

IRS–National Computer Center
Post Office Box 1359
Martinsburg, WV 25401-1359
or
IRS–National Computer Center
Route 9 & Needy Road
Martinsburg, WV 25401

Hours of operation at this address will be 8:30 A.M. until 6:00 P.M. Eastern Time Zone. The telephone number is (304) 263-8700.

Requests for paper returns, publications or forms not related to magnetic media processing should be requested by calling the toll-free Forms only number in your area.

.02 The National Computer Center will process returns filed on magnetic media only. All information returns, including corrections, that are filed on paper forms should be submitted to the appropriate service center, not the IRS National Computer Center. Organizations who file their information returns on magnetic media but who submit their corrected returns on paper forms refer to the 1988 "Instructions for Forms 1099, 1098, 5498, 1096, and W-2G" for the service center addresses.

Section 12. Combined Federal/State Filing

.01 The Combined Federal/State Program was established to simplify information returns filing for the taxpayer. IRS will accept, upon prior approval, magnetic media files containing state reporting information only for those states listed in Table 1 in this section. FORMS 1098, 1099-A, 1099-B, *1099-S*, AND W-2G CANNOT BE FILED UNDER THE COMBINED FEDERAL/STATE FILING PROGRAM.

.02 To request approval to participate in the Combined Federal/State Program, a "test" file, coded for this program, must be submitted by the transmitter to the IRS National Computer Center between October 1 and December 15 using the revenue procedure that will be used for the actual data files. Blanket approval will not be given to software packages. ATTACH A LETTER TO THE FORM 4804 SUBMITTED WITH THE "TEST" FILE WHICH INDICATES THAT YOU WISH TO PARTICIPATE IN THIS PROGRAM. The "test" file is only required for the first year. Once you are approved, you do not need to resubmit "tests" each year, except when notified by IRS. Refer to Part A, Sec. 11 for the address. See Part A, Sec. 3.04 for general guidelines on submission of "test" files. Each record, both in the "test" file and actual data file, must conform exactly to the revenue procedure for the tax year of the actual data. Combined Federal/State records must be coded using each state's dollar criteria from Table 2 of this section for each type of return.

If the *"test"* file is determined to be acceptable, IRS will return it to the filer with Form 6847, Consent For Internal Revenue Service to Release Tax Information. The payer must complete Form 6847. The five character alpha/numeric Transmitter Control Code must be included on the form. The form must then be returned to IRS before IRS will release tax information to any of the participating states.

Form 6847 must be signed by one of the individuals listed at the bottom of the form and returned to the address listed in Part A, Sec. 11. If the form is signed by an attorney-in-fact, the written consent from the taxpayer to the attorney-in-fact must be included with the Form 6847. This consent by language and/or scope must clearly indicate that the attorney-in-fact is empowered to authorize release of the information document returns to the state(s). A separate Form 6847 is required for each payer. A transmitter may not combine payers on one Form 6847 even though acting as attorney-in-fact for several payers. Form 6847 may be photocopied if you receive an insufficient number of the forms. *A computer generated Form 6847 may also be used as long as the generated form includes the same information as the official Form 6847.* If you have filed on this program in the past and have not met these requirements, you must resubmit the Form 6847 with the proper signatures as specified. If you file for multiple payers, code the records to go to the state(s) only for those payers that participate and have properly submitted Form 6847. Do not submit actual data records coded for the Combined Federal/State Program without prior approval from IRS.

.03 States that participate in this program and the valid state code assigned to each are listed in Table 1 of this section. If the state that you wish information released to does not participate in the program, do not code your records for that state. If the state participates, if you have received prior approval, and if all other conditions are met, IRS will forward the tax information to the participating state at no charge to the filer. You do not need to reapply for this program each year.

.04 IF CORRECTIONS MUST BE MADE, IRS WILL NOT TRANSMIT CORRECTED RETURNS TO THE STATES; THIS WILL BE THE RESPONSIBILITY OF THE FILER.

.05 IRS will make no attempt to process files with any deviations. Approval to participate in the Combined Federal/State Program will be revoked if any files are submitted that do not totally conform.

.06 IRS is acting as a forwarding agent ONLY. Some participating states require separate notification that you are filing in this manner. It is your responsibility to contact the appropriate states for further information.

.07 The appropriate state code should be entered for those documents which meet that state's filing requirements. It is the filer's responsibility to determine the state code to be used and to obtain the filing requirements from the appropriate state(s).

.08 If you meet all of the requirements for this program, you must provide the state totals from the "K" Record on a separate Form 4804, Transmittal of Information Returns on Magnetic Media (or Form 4802, Transmittal For Multiple Magnetic Media Reporting) or computer generated substitute for each state, or you must include a listing which identifies each state and the "K" Record totals for each.

.09 If you have met ALL of the above conditions:

(a) You must submit all records which indicate the appropriate coding related to this program.

(b) The "C" Record must be followed by a "K" Record for each state. The "K" Record indicates the number of payees being reported to each particular state.

(c) Payment amount totals and the valid participating state code must be included in the state totals "K" Record. Refer to Part B, Sec. 8, for a description of the "K" Record.

(d) The "K" Record is followed by an end of transmission "F" Record (if this is the last record of the entire file).

.10 Only those states listed in Table 1 will receive information from IRS. It is the filer's responsibility to file information returns with states that do not participate in this program.

TABLE 1. Participating States and their Codes

State	Code	State	Code	State	Code
Alabama	01	Iowa	19	New York	36
Arizona	04	Kansas	20	North Carolina	37
Arkansas	05	Maine	23	North Dakota	38
California	06	Massachusetts	25	Oregon	41
Delaware	10	Minnesota	27	South Carolina	45
District of Columbia	11	Mississippi	28	Tennessee	47
Georgia	13	Missouri	29	Wisconsin	55
Hawaii	15	Montana	30		
Idaho	16	New Jersey	34		
Indiana	18	New Mexico	35		

.11 To simplify filing, several of the participating states have provided lists of their information return reporting requirements (see Table 2). This cumulative list is for information purposes only and represents dollar criteria. For complete information on state filing requirements, contact the appropriate state tax agencies.

Table 2. Dollar Criteria

State	1099-DIV	1099-G	1099-INT	1099-MISC	1099-OID	1099-PATR	1099-R	5498
Alabama	$1500	$ NR	$1500	$1500	$1500	$1500	$1500	NR
Arizona[a]	300	300	300	300	300	300	300	NR
Arkansas	100	2500	100	2500	2500	2500	2500	g
District of Columbia[b]	600	600	600	600	600	600	600	NR
Hawaii	10	h	10[c]	600	10	10	600	g
Idaho	10	10	10	600	10	10	600	g
Iowa	100	1000	1000	1000	1000	1000	1000	NR
Minnesota	10	10	10	600	10	10	600	g
Missouri	NR	NR	NR	1200[d]	NR	NR	NR	NR
Montana	10	10	10	600	10	10	600	g
New Jersey	1000	1000	1000	1000	1000	1000	1000	NR
New York	NR	600	600	600[e]	NR	600	600	NR
North Carolina	100	100	100	600	100	100	100	g
Oregon	10	10	10	600	10	10	600[f]	g
Tennessee	25	NR	25	NR	NR	NR	NR	NR
Wisconsin	600	NR	600	100	NR	600	600	NR

NR–No filing requirement.

Footnotes:

a. These requirements apply to individuals and business entities.

b. Amounts are for aggregates of several types of income from the same payroll.

c. State regulation changing filing requirement from $600 to $10 is pending.

d. The state would prefer those returns filed with respect to non-Missouri residents to be sent directly to the state agency.

e. Aggregate of several types of income.

f. Return required for state of Oregon residents only.

g. Same as Federal requirement for this type of return.

h. All forms are to be reported.

*NOTE: Filing requirements for any state in Table 1 not shown on the above chart are the same as the Federal requirement.

Section 13. Definitions of Terms

Element	*Description*
b	**Denotes a blank position. Enter blank(s) when this symbol is used (do not enter the letter "b"). This appears in numerous areas throughout the record descriptions.**
Coding Range	**Indicates the allowable codes for a particular type of statement.**
EIN	**Employer Identification Number that has been assigned by IRS to the reporting entity.**
Excess Golden Parachute Payments	**Parachute payments (also called "golden parachutes") are certain payments in the nature of compensation that corporations make to key individuals, often in excess of their usual compensation, in the event that ownership or control of the corporation changes.**
File	*For purposes of this procedure, a file consists of all magnetic media records submitted by a Payer or Transmitter.*
Foreign Corporation	**Any corporation organized or created other than in or under the laws of the United States or any state or territory.**
PS 58 Costs	**The current cost of life insurance under a qualified plan taxable under section 72(m) and Regulations section 1.72-16(b). See Part B, Sec. 6 Payee "B" Record, Document Specific Code, Category of Total Distribution, Code 9.**
Payee	**Person(s) or organization(s) receiving payments from the Payer, or for whom an information return must be filed. The payee includes a borrower (Form 1099-A), participant (Form 5498) and a winner (Form W-2G). For Form 1098, the payee is the individual paying the interest.** ***For Form 1099-S, the payee is the seller or other transferor.***
Payer	**Includes the person making payments, a recipient of mortgage interest payments (Form 1098), a broker (Form 1099-B), a person reporting a real estate transaction (Form 1099-S), a barter exchange, a trustee or issuer of an IRA or SEP, or a lender who acquires an interest in secured property or who has reason to know that the property has been abandoned. The Payer will be held responsible for the completeness, accuracy and timely submission of magnetic media files.**
Special Character	Any character that is not a numeral, a letter, or a blank.
SSA	Social Security Administration.
SSN	Social Security Number.
Taxpayer Identification Number (TIN)	May be either an EIN or SSN.
Transfer Agent (Paying Agent)	The transfer agent or paying agent is the entity who has been contracted or authorized by the payer to perform the services of paying and reporting backup withholding (Form 941). The payer must submit to IRS a Form 2678, Employer Appointment of Agent under Section 3504, which notifies IRS of the transfer agent relationship.
Transmitter	Person or organization *submitting* magnetic media file(s). May be Payer or agent of Payer.
Transmitter Control Code (TCC)	A five character alpha/numeric number assigned by IRS to the transmitter prior to actual filing on magnetic media. This number is inserted in the "A" Record of your files and must be present before the file can be processed. An application Form 4419 must be filed with IRS to receive this number. See Part A, Sec. 3. (Abbreviation for this term is TCC.)

Section 14. State Abbreviations

.01 You MUST use the following state abbreviations when developing the state code portion of address fields. (This table provides state abbreviations only and does not represent those states participating in the Combined Federal/State Program. For a list of states that participate in the Combined Federal/State Program, refer to Part A, Sec. 12.10.)

State	Code	State	Code	State	Code
Alabama	AL	Kentucky	KY	North Dakota	ND
Alaska	AK	Louisiana	LA	Ohio	OH
Arizona	AZ	Maine	ME	Oklahoma	OK
Arkansas	AR	Maryland	MD	Oregon	OR
California	CA	Massachusetts	MA	Pennsylvania	PA
Colorado	CO	Michigan	MI	Rhode Island	RI
Connecticut	CT	Minnesota	MN	South Carolina	SC
Delaware	DE	Mississippi	MS	South Dakota	SD
District of Columbia	DC	Missouri	MO	Tennessee	TN
Florida	FL	Montana	MT	Texas	TX
Georgia	GA	Nebraska	NE	Utah	UT
Hawaii	HI	Nevada	NV	Vermont	VT
Idaho	ID	New Hampshire	NH	Virginia	VA
Illinois	IL	New Jersey	NJ	Washington	WA
Indiana	IN	New Mexico	NM	West Virginia	WV
Iowa	IA	New York	NY	Wisconsin	WI
Kansas	KS	North Carolina	NC	Wyoming	WY

.02 *In the past, IRS has provided a list of foreign country codes. These codes have been eliminated for tax year 1988.* You may enter foreign addresses using a 40 position free format rather than the 29-2-9 format for the Payee City, Payee State and Payee ZIP Code; however, this is only allowable if a "1" appears in the Foreign Country Indicator field. This 40 position free format may only be used for foreign addresses. *You may choose to spell out the name of the foreign country or use abbreviations.* Addresses in the United States must use the state codes provided and must be in the 29-2-9 format.

Part B. Magnetic Media Specifications

Section 1. General

.01 The specifications contained in this part of the revenue procedure define the required format and contents of the records to be included in the magnetic media file. These specifications must be adhered to unless deviations have been specifically granted by IRS.

.02 An external affixed label, Form 5064, must appear on each tape and diskette submitted for processing. *If diskettes are used and the operating system is not MS/DOS compatible, the operating system and hardware information MUST be provided. Failure to provide this information will result in the diskette being returned to the filer.* The following information is needed:

(a) The transmitter's name.

(b) The five character alpha/numeric Transmitter Control Code.

(c) The tax year of the data (*e.g.*, 1988).

(d) *Operating system and hardware used to create the file (e.g., Apple MacIntosh/MacWrite V2.2).*

(e) Document types (*e.g.*, 1099-09-INT).

(f) The total number of "B" Records after each "A" Record (this figure is taken from the "C" Records).

(g) An in-house number assigned by the transmitter to the magnetic media (if applicable).

(h) The sequence of each tape or diskette (*e.g.*, 001 of 008).

The external media label, Form 5064, was updated in tax year 1988. You must use the updated label. This information will assist IRS in processing the file or in locating a file, should the transmitter request that it be returned due to errors. *IRS advises that special shipping containers not be used for transmitting data since they will not be returned.*

.03 A provision is made in the Payee "B" Records for Special Data Entries. These entries are optional. If the field is not utilized, enter blanks to maintain a fixed record length of 420 positions. The field is intended to serve one or both of these purposes:

(a) Contain information required by state or local governments. Filers who wish to use this option for satisfying state or local reporting requirements should contact their state or local department of revenue for filing instructions. Also refer to Part A, Sec. 12.

(b) This field is also reserved for the filer's own personal use and may be used at the discretion of the filer to include information related to each individual return. IRS will not use the information supplied in this field. (The length of this field will vary depending on the type of return. For Forms 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, and 5498, there are 67 positions reserved for Special Data Entries. *For Form 1099-A, there are 21 positions, for Form 1099-B, there are 10 positions, for Forms 1099-OID, there are 28 positions and for Forms 1099-09S, there are 23 positions.* Form W-2G has no available space within the Payee "B" Record for Special Data Entries.

.04 All records must be a fixed length of 420 positions. Use "K" Records *only* if you are an approved Combined Federal/State filer.

Section 2. Tape Specifications

.01 In most instances, IRS will be able to process any compatible tape files. Tape files must be EBCDIC, ASCII or BCD and must meet the following criteria:

(a) 9 track EBCDIC (Extended Binary Coded Decimal Interchange Code) with

(1) Odd Parity and

(2) A density of 800, 1600, or 6250 BPI.

(3) If you use UNIVAC Series 1100, you must submit an interchange tape.

(b) 9 track ASCII (American Standard Coded Information Interchange) with

(1) Odd Parity and

(2) A density of 800, 1600, or 6250 BPI.

(c) 7 track BCD (Binary Coded Decimal) with

(1) Either Even or Odd Parity and

(2) A density of 556 or 800 BPI. (IRS will accept and process 7 track tapes; however, 9 track is preferred.)

Please be consistent in the use of recording codes and density on your files. If files are generated in more than one recording code and/or density, multiple shipments would be appreciated.

.02 All compatible tape files must have the following characteristics: Type of tape – 0.5 inch (12.7 mm) wide, computer grade magnetic tape on reels of up to 2400 feet (731.52 m) within the following specifications:

(a) Tape thickness: 1.0 or 1.5 mils and

(b) Reel diameter: 10.5 inch (26.67 cm), 8.5 inch (21.59 cm), or 7 inch (17.78 cm).

(c) At this time, IRS cannot accept cartridge tape.

.03 Payers who can substantially conform to these specifications, but who require some minor deviations, MUST contact the IRS National Computer Center. Under no circumstances may tapes deviating from the specifications in this revenue procedure be submitted without prior approval from IRS. If you file on the Combined Federal/State Program, your files must conform totally to this revenue procedure.

.04 The tape records defined in this revenue procedure may be blocked or unblocked, subject to the following:

(a) A block must not exceed 10,000 tape positions.

(b) If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9's; however, the last block of the file may be filled with 9's or truncated. Do not pad a block with blanks.

(c) All records, except the Header and Trailer Labels, may be blocked.

(d) Records may not span blocks.

.05 Labeled or unlabeled tapes may be submitted.

.06 For the purposes of this revenue procedure the following must be used. Tape Mark:

1. Used to signify the physical end of the recording on tape.

2. For even parity, use BCD configuration 001111 ("8421").

3. May follow the header label and precede and/or follow the–trailer label.

best copy available

Section 3. 5¼ Inch and 3½ Inch Diskette Specifications

.01 To be compatible, a diskette file must meet the following specifications:

(a) 5¼ or 3½ inches in diameter.

(b) Data must be recorded in standard ASCII code.

(c) Records must be fixed length of 420 bytes per record.

(d) Delimiter character commas (,) must not be used.

(e) Position 419 and 420 of each record has been reserved for carriage return/line feed (cr/lf) characters.

(f) Filename of IRSTAX must be used. If a file will consist of more than one diskette, the filename IRSTAX will contain a 3 digit numeric extension. This extension will indicate the sequence of the diskettes within the file. For example, the first diskette will be named IRSTAX.001, the second diskette will be IRSTAX.002 etc.

(g) A diskette file may consist of multiple diskettes as long as the filename conventions are adhered to.

(h) Diskettes must meet one of the following specifications:

Capacity	Tracks	Sides/ Density	Size Sector
1.44 mb	96tpi	hd	512
1.2 mb	96tpi	hd	512
720 kb	48tpi	ds/dd	512
360 kb	48tpi	ds/dd	512
320 kb	48tpi	ds/dd	512
180 kb	48tpi	ss/dd	512
160 kb	48tpi	ss/dd	512

.02 IRS prefers that 5¼ and 3½ inch diskettes be created using MS/DOS, however, diskettes created using other operating systems are acceptable. A test file submission is highly recommended for 5¼ and 3½ inch diskettes, especially if the file is not MS/DOS (see Part A, Section 3.04 for instructions on submitting "test" files).

.03 Deviations from the prescribed formats will not be acceptable. Under no circumstances may diskettes deviating from the specifications in this revenue procedure be submitted without prior approval from IRS. If you file under the Combined Federal/State Program, your files must conform totally to this revenue procedure.

Section 4. Payer/Transmitter "A" Record

.01 Identifies the payer and transmitter of the magnetic media file and provides parameters for the succeeding Payee "B" Records. IRS computer programs rely on the absolute relationship between the parameters and data fields in the "A" Record and the data fields in the "B" Records to which they apply.

.02 The number of "A" Records appearing on a tape reel or diskette will depend on the number of payers and the different types of returns being reported. The payment amounts for one payer for one type of return must be consolidated under one "A" Record if submitted on the same file. Do not submit separate "A" Records for each payment amount being reported. For example, if you are filing Form 1099–DIV to report Amount Codes 1, 2, and 3, all three amount codes must be reported under one "A" Record, not three separate "A" Records. For Payee "B" Records which do not contain payment amounts for all three amount codes, enter zeros for those which have no payment to be reported. The first record appearing on the file must be an "A" Record. All records must be a fixed length of 420 positions. A transmitter may include Payee "B" Records for more than one payer on a tape reel or diskette; however, each GROUP of Payee "B" Records must be preceded by an "A" Record. A single tape reel or diskette may also contain different types of returns, but the types of returns must not be intermingled. A separate "A" Record is required for each payer and each type of return being reported. An "A" Record may be blocked with "B" Records; however, the initial record on a file must be an "A" Record. IRS will accept an "A" Record after a "C" Record. Do not begin any record at the end of a block or diskette and continue the same record into the next block.

.03 All alpha characters entered in the "A" Record should be upper-case.

.04 WHEN REPORTING FORM 1098, MORTGAGE INTEREST STATEMENT, THE "A" RECORD WILL REFLECT THE NAME OF THE RECIPIENT OF THE INTEREST (THE FILER). THE "B" RECORD WILL REFLECT THE INDIVIDUAL PAYING THE INTEREST (BORROWER/PAYER OF RECORD) AND THE AMOUNT PAID.

RECORD NAME: PAYER/TRANSMITTER "A" RECORD

NOTE: For all fields marked REQUIRED, you must provide the information described under Description and Remarks. For those fields *not* marked REQUIRED, you must allow for the field but may be instructed to enter blanks or zeros in the indicated tape position(s) and for the indicated length. All records are now a fixed length of 420 positions.

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	REQUIRED. Enter "A".
2-3	Payment Year	2	REQUIRED. Must be the last two digits of the year for which information is being reported. (e.g., if payments were made in 1988, enter "88"). Must be incremented each year.
4-6	Reel Sequence Number	3	The reel sequence number incremented by 1, for each tape or diskette on the file starting with 001. You may choose to enter blanks or zeros in this field. IRS bypasses this information. You must indicate the proper sequence on the external label Form 5064.
7-15	Payer's Federal EIN	9	REQUIRED. Must be the valid 9-digit number assigned to the payer by IRS. DO NOT ENTER BLANKS, HYPHENS, ALPHA CHARACTERS, ALL 9s OR ALL ZEROS. (Also see Part A, Sec 9.07.). *For Foreign Corporations that are not required to have an EIN, this field may be left blank. Foreign Corporations should have the Foreign Corporation Indicator set to "1." See Part A, Section 13 for the definition of a Foreign Corporation.*

RECORD NAME: PAYER/TRANSMITTER "A" RECORD (Continued)

<table>
<tr><th>Field Position</th><th>Field Title</th><th>Length</th><th>Description and Remarks</th></tr>
<tr><td>16-19</td><td>Payer Name Control</td><td>4</td><td>The Payer Name Control can be obtained from the mail label on the Package 1099 that is mailed to most payers on record each December. Names of less than (4) four letters should be left-justified, filling the unused positions with blanks. If you have not received a Package 1099 or you do not know your Payer Name Control, this field should be blank filled.</td></tr>
<tr><td>20</td><td>Blank</td><td>1</td><td>Enter blank.</td></tr>
<tr><td>21</td><td>Combined Federal/State Filer</td><td>1</td><td>Enter the appropriate code from the table below. Prior approval is required. A Consent Form 6847 must be submitted to IRS before tax information will be released to the States. Refer to Part A, Sec. 12.11 for money criteria. Not all states participcte in this program. If the Payer/Transmitter is not participating in the Combined Federal/State Filing Program, enter blanks. (Refer to Part A, Sec. I2 for the requirements that must be met prior to actual participation in this program.) Forms 1098, 1099-A, 1099-B, <i>1099-S</i>, and W-2G cannot be filed on this program. Filers who participate in this program must incorporate state totals into corresponding "K" Records as described in Part B, Sec. 8.
<table>
<tr><th><i>Code</i></th><th><i>Meaning</i></th></tr>
<tr><td>1</td><td>Participating in the Combined Federal/State Filing Program.</td></tr>
<tr><td>blank</td><td>Not participating.</td></tr>
</table></td></tr>
<tr><td>22</td><td>Type of Return</td><td>1</td><td>REQUIRED. Enter appropriate code from table below:
<table>
<tr><th><i>Type of Return</i></th><th><i>Code</i></th></tr>
<tr><td>1098</td><td>3</td></tr>
<tr><td>1099-A</td><td>4</td></tr>
<tr><td>1099-B</td><td>B</td></tr>
<tr><td>1099-DIV</td><td>1</td></tr>
<tr><td>1099-G</td><td>F</td></tr>
<tr><td>1099-INT</td><td>6</td></tr>
<tr><td>1099-MISC</td><td>A</td></tr>
<tr><td>1099-OID</td><td>D</td></tr>
<tr><td>1099-PATR</td><td>7</td></tr>
<tr><td>1099-R</td><td>9</td></tr>
<tr><td><i>1099-S</i></td><td><i>S</i></td></tr>
<tr><td>5498</td><td>L</td></tr>
<tr><td>W-2G</td><td>W</td></tr>
</table></td></tr>
<tr><td>23-31</td><td>Amount Indicators</td><td>9</td><td>REQUIRED. In most cases, the box numbers on paper information returns correspond with the Amount Codes used to file on magnetic media; however, should you notice discrepancies between this revenue procedure and paper forms, please disregard them and program according to this revenue procedure for your returns filed on magnetic media. For specific instructions on information to be reported in each Amount Code, refer to the 1988 "Instructions for Forms 1099, 1098, 5498, 1096, and W-2G," included in your magnetic media reporting packages. The amount indicators entered for a given type of return indicate type(s) of payment(s) that were made. For each Amount Code entered in this field, a corresponding payment amount will appear in the Payee "B" Record. Example: If position 22 of the Payer/Transmitter "A" Record is "7" (for 1099-PATR) and positions 23-31 are "247bbbbbb," this indicates that you will be reporting 3 actual payment amounts in all of the following Payee "B" Records. The first payment amount field in the Payee "B" Record will be all "0" (zeros), the second will represent Nonpatronage distributions, the third will be all "0" (zeros), the fourth will represent Federal income tax withheld, the fifth and sixth will be all "0" (zeros), the seventh will represent Energy investment credit, and the eighth and ninth will be all "0" (zeros). Enter the Amount Indicators in ASCENDING SEQUENCE (i.e., 1247bbbbb), left-justify, filling unused positions with blanks. For any further clarification of the Amount Indicator codes, contact the IRS National Computer Center.</td></tr>
</table>

Field Position	Field Title	Length	Description and Remarks	
	Amount Indicators Form 1098—Mortgage Interest Statement		For Reporting Interest Received from Payers/Borrowers *(Payer of Record)* on Form 1098:	
			Amount Code	Amount Type
			1	Mortgage interest received from payer(s)/ borrower(s)
	Amount Indicators Form 1099–A—Acquisition or Abandonment of Secured Property		For Reporting the Acquisition or Abandonment of Secured Property on Form 1099–A:	
			Amount Code	Amount Type
			2	Amount of debt outstanding
			3	Amount of debt satisfied
			4	Fair market value of property at acquisition or abandonment
	Amount Indicators Form 1099–B—Proceeds From Broker and Barter Exchange Transactions		For Reporting Payments on Form 1099–B:	
			Amount Code	Amount Type
			2	Stocks, bonds, etc. (For Forward Contracts see NOTE 1 below.)
			3	Bartering (Do not report negative amounts)
			4	Federal income tax withheld
			6	Profit (or loss) realized in 1988
			7	Unrealized profit (or loss) on open contracts—12/31/87
			8	Unrealized profit (or loss) on open contracts—12/31/88
			9	Aggregate profit (or loss)

NOTE 1: The Payment Amount field associated with Amount Code 2 may be used to represent a loss when the reporting is for Forward Contracts. Refer to Payee "B" Record—General Field Descriptions, Payment Amount Fields, for instructions on reporting negative amounts. Do not report negative amounts for Amount Codes 3 and 4.

	Amount Indicators Form 1099–DIV—Dividends and Distributions		For Reporting Payments on Form 1099–DIV:	
			Amount Code	Amount Type
			1	Gross dividends and other distributions on stock
			2	Investment expenses included in Amount Code 1
			3	Capital gain distributions
			4	Federal income tax withheld
			5	Nontaxable distributions (if determinable)
			6	Foreign tax paid
			8	Cash liquidation distributions
			9	Noncash liquidation distributions (Show fair market value)
	Amount Indicators Form 1099–G—Certain Government Payments		For Reporting Payments on Form 1099–G:	
			Amount Code	Amount Type
			1	Unemployment compensation
			2	State or local income tax refunds
			4	Federal income tax withheld
			5	Discharge of indebtedness
			6	Taxable grants
			7	Agriculture payments

RECORD NAME: PAYER/TRANSMITTER "A" RECORD (Continued)

Field Position	Field Title	Length	Description and Remarks	
	Amount Indicators Form 1099-INT—Interest Income		For Reporting Payments on Form 1099-INT:	
			Amount Code	Amount Type
			1	Earnings from savings and loan associations, credit unions, bank deposits, bearer certificates of deposit, etc.
			2	Early withdrawal penalty
			3	U.S. Savings Bonds, etc.
			4	Federal income tax withheld
			5	Foreign tax paid (if eligible for foreign tax credit)
	Amount Indicators Form 1099-MISC—Miscellaneous Income (See NOTES 1, 2, 3 and 4)		For Reporting Payments on Form 1099-MISC:	
			Amount Code	Amount Type
			1	Rents
			2	Royalties
			3	Prizes and awards
			4	Federal income tax withheld
			5	Fishing boat proceeds
			6	Medical and health care payments
			7	Nonemployee compensation (see NOTE 1)
			8	Substitute payments in lieu of dividends or interest (see NOTE 2)
			9	Direct sales "indicator" (see NOTE 3)

NOTE 1: Amount code "7" is normally used to report nonemployee compensation. Amount code "7" can also be used however, to report crop insurance proceeds. See Part B, Section 6, Document Specific Code for instructions on how to indicate Crop Insurance Proceeds.

NOTE 2: Brokers who transfer securities of a customer for use in a short sale must use Amount Code 8 to report the aggregate payments received in lieu of dividends or tax-exempt interest on behalf of a customer while the short sale was open. Generally, for substitute payments in lieu of dividends, a broker is required to file a Form 1099-MISC for each affected customer who is not an individual. Refer to the 1988 "Instructions for Forms 1099, 1098, 5498, 1096, and W-2G," for detailed information. The instructions are included in your magnetic media reporting packages.

NOTE 3: Use Amount Code "9" to report sales by you of $5,000 or more of consumer products to a person on a buy-sell, deposit-commission, or any other commission basis for resale. Refer to the 1988 "Instructions for Forms 1099, 1098, 5498, 1096, and W-2G," for specific instructions. Do not use this indicator for sales of less than $5,000. The use of Amount Code "9" actually reflects an indicator of direct sales over $5,000 and is not an actual payment amount or amount code. The corresponding payment amount field in the Payee "B" Record MUST be reflected as 0000000100 if you are reporting direct sales of greater than $5000. This does not mean that a payment of $1.00 was made or is being reported.

NOTE 4: If you are reporting Excess Golden Parachute Payments, use paper forms 1099-MISC. Do not report these payments on magnetic media. See Part A, Sec. 13 for a definition of an Excess Golden Parachute Payment.

Field Position	Field Title	Length	Description and Remarks	
	Amount Indicators Form 1099-OID—Original Issue Discount		For Reporting Payments on Form 1099-OID:	
			Amount Code	Amount Type
			1	Total original issue discount for 1988
			2	Other periodic interest
			3	Early withdrawal penalty
			4	Federal income tax withheld

RECORD NAME: PAYER/TRANSMITTER "A" RECORD—Continued

Field Position	Field Title	Length	Description and Remarks	
	Amount Indicators Form 1099--PATR—Taxable Distributions Received From Cooperatives		For Reporting Payments on Form 1099-PATR:	
			Amount Code	Amount Type
			1	Patronage dividends
			2	Nonpatronage distributions
			3	Per-unit retain allocations
			4	Federal income tax withheld
			5	Redemption of nonqualified notices and retain allocations
			6	Investment credit (See NOTE)
			7	Energy investment credit (See NOTE)
			8	Jobs credit (See NOTE)
			9	*Low-income housing credit (see NOTE)*

NOTE: The amounts shown for Amount Indicators "6," "7," "8," and "9" must be reported to the payee; however, they need not be reported to IRS.

Field Position	Field Title	Length	Description and Remarks	
	Amount Indicators Form 1099-R—Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.		For Reporting Payments on Form 1099-R:	
			Amount Code	Amount Type
			1	*Gross distribution*
			2	*Taxable amount*
			3	*Amount in Amount Code 2 eligible for capital gain election*
			4	Federal income tax withheld
			5	Employee contributions or insurance premiums
			6	Net unrealized appreciation in employer's securities
			8	*Other*
			9	*State income tax withheld (see NOTE 1)*

NOTE 1: State income tax withheld has been added for the convenience of the payer but need not be reported to IRS.

Field Position	Field Title	Length	Description and Remarks	
	Amount Indicators Form 1099-S-: Proceeds From Real Estate Transactions		*For Reporting Payments on Form 1099-S:*	
			Amount Code	Amount Type
			2	*Gross proceeds*
	Amount Indicators Form 5498—Individual Retirement Arrangement Information (See NOTE)		For Reporting Payments on Form 5498:	
			Amount Code	Amount Type
			1	Regular IRA contributions made in 1988 and 1989 for 1988
			2	Rollover IRA contributions
			3	Life insurance cost included in amount code 1
			4	Fair market value of the IRA or SEP account *at the end of the year*

NOTE: Form 5498 is filed for each person for whom you maintained an individual retirement arrangement (IRA) or simplified employee pension (SEP) during 1988. Amount Code 4 represents the value of the account. Trustees and issuers of IRAs and SEPs must report the value of accounts in existence during the year, even if no contributions were made during the year. *However, if a total distribution was made from an IRA during the year and no contributions were made for that year, you need not file Form 5498 to reflect that the fair market value on December 31 was zero.* Do not report employer SEP contributions on Form 5498; however, you must report the value of an SEP account. For an IRA, use all applicable Amount Codes. If no IRA contributions were made for 1988, you will only use Amount Code 4. Only IRA contributions to be applied to 1988 that are made between January 1, 1988, and April 17, 1989, are to be reported in Amount Code 1.

RECORD NAME: PAYER/TRANSMITTER "A" RECORD—Continued

Field Position	Field Title	Length	Description and Remarks
	Amount Indicators Form W-2G—Certain Gambling Winnings		For Reporting Payments on Form W-2G: Amount Code — Amount Type 1 — Gross winnings 2 — Federal income tax withheld 3 — State income tax withheld (See NOTE) 7 — Winnings from identical wagers NOTE: State income tax withheld has been added for the convenience of the payer but need not be reported to IRS.
32–43	Blank	12	Enter blanks.
44–48	Transmitter Control Code (TCC)	5	REQUIRED. Enter the five character alpha/numeric Transmitter Control Code assigned by IRS. See Part A, Sec. 13 for a definition of Transmitter Control Code (TCC). You must have a TCC to file actual data on this program.
49	Foreign Corporation Indicator	1	Enter a "1" if the payer is a foreign corporation and income is paid by the corporation to a U.S. resident from sources outside of the United States. See Part A, Section 13 for a definition of a Foreign Corporation. If the payer is not a Foreign Corporation, enter blank.
50–89	First Payer Name Line	40	REQUIRED. Must be present or files will be returned for correction. Enter the name of the payer whose Federal EIN appears in positions 7–15 of the "A" Record, in the manner in which it is used in normal business. Any extraneous information must be deleted from the name line. Left-justify and fill with blanks. (Do not enter the Transfer Agent's name in this field. The Transfer Agent's name should appear in the Second Payer Name Line.) NOTE: WHEN REPORTING FORM 1098, MORTGAGE INTEREST STATEMENT, THE "A" RECORD WILL REFLECT THE NAME OF THE RECIPIENT OF THE INTEREST (*THE FILER*). THE "B" RECORD WILL REFLECT THE INDIVIDUAL PAYING THE INTEREST (THE PAYER OF RECORD) AND THE AMOUNT PAID. *FOR FORM 1099–S, THE "A" RECORD WILL REFLECT THE PERSON RESPONSIBLE FOR REPORTING TRANSACTION AND THE "B" RECORD WILL REFLECT THE SELLER.*
90–129	Second Payer Name Line	40	The contents of this field are dependent upon the TRANSFER AGENT INDICATOR in position 130 of this record. If the Transfer Agent Indicator contains a "1," this field must contain the name of the Transfer Agent. If the Transfer Agent Indicator contains a "0" (zero), this field must contain either a continuation of the First Payer Name field or blanks. Left-justify and fill unused positions with blanks. IF NO ENTRIES ARE PRESENT FOR THIS FIELD, FILL WITH BLANKS. (See Part A, Sec. 13 for a definition of Transfer Agent.)
130	Transfer Agent Indicator	1	REQUIRED. Identifies the entity in the Second Payer Name field. (See Part A, Sec. 13 for a definition of Transfer Agent.) *Code* — *Meaning* 1 — The entity in the Second Payer Name field is the Transfer Agent. 0 (zero) — The entity shown is not the Transfer Agent (i.e., the Second Payer Name field contains either a continuation of the First Payer Name field or blanks).
131–170	Payer Shipping Address	40	REQUIRED. If the TRANSFER AGENT INDICATOR in position 130 is a "1" enter the shipping address of the Transfer Agent. Otherwise, enter the shipping address of the payer. Left-justify and fill with blanks.
171–210	Payer City, State, and ZIP Code	40	REQUIRED. If the TRANSFER AGENT INDICATOR in position 130 is a "1" enter the City, State, and ZIP Code of the Transfer Agent. Otherwise, enter the City, State, and ZIP Code of the payer. Left-justify and fill with blanks.

RECORD NAME: PAYER/TRANSMITTER "A" RECORD—Continued

Field Position	Field Title	Length	Description and Remarks
211-290	Transmitter Name	80	**REQUIRED (only if the payer and transmitter are not the same). Enter the name of the transmitter in the manner in which it is used in normal business. The name of the transmitter must be reported in the same manner through the entire file. Left-justify and fill with blanks. If the payer and transmitter are the same, enter blanks in this field.**
291-330	Transmitter Mailing Address	40	**REQUIRED (only if the payer and transmitter are not the same). Enter the mailing address of the transmitter. Left-justify and fill with blanks. If the payer and transmitter are the same, enter blanks in this field.**
331-370	Transmitter City, State, and ZIP Code	40	**REQUIRED (only if the payer and transmitter are not the same). Enter the City, State, and ZIP Code of the transmitter. Left-justify and fill with blanks. If the payer and transmitter are the same, enter blanks in this field.**
371-420	Blank	50	**Enter blanks.**

Section 5. Payer/Transmitter "A" Record—Record Layout

RECORD TYPE	PAYMENT YEAR	REEL SEQUENCE NUMBER	PAYER'S FEDERAL EIN*	PAYER NAME CONTROL*	BLANK	COMBINED FEDERAL/STATE FILER
1	2-3	4-6	7-15	16-19	20	21

TYPE OF RETURN	AMOUNT INDICATORS	BLANK	TRANSMITTER CONTROL CODE	FOREIGN CORPORATION INDICATOR	FIRST PAYER NAME*	SECOND PAYER NAME*
22	23-31	32-43	44-48	49	50-89	90-129

TRANSFER AGENT INDICATOR	PAYER SHIPPING ADDRESS*	PAYER CITY, STATE, AND ZIP CODE*	TRANSMITTER NAME	TRANSMITTER MAILING ADDRESS
130	131-170	171-210	211-290	291-330

TRANSMITTER CITY, STATE, AND ZIP CODE	BLANK
331-370	371-420*

When reporting Form 1098 Mortgage Interest Statement, the "A" record will reflect the name of the recipient of the interest (the filer).** ***For Form 1099-S, the "A" Record will reflect the person responsible for reporting the transaction.

Section 6. Payee "B" Record—General Field Descriptions and Record Layouts

.01 The Payee "B" Record contains the payment information from the individual statements. When filing information documents on magnetic media, the format for the Payee "B" Records will remain constant and is a fixed length of 420 positions. The record layout for positions 1 through 321 is the same for all "B" Records. Positions 322 through 420 varies slightly for Forms 1099-A, 1099-B, 1099-OID, 1099-S and W-2G to accommodate variations within these forms. The individual field definitions can be found following the Payee Zip Code field in the "B" Record.

All records must be submitted with a fixed length of 420 positions. In the "A" Record, the Amount Indicator Codes that appear in tape or diskette positions 23 through 31 will be left-justified and blank filled. In the "B" Record, you will allow for all nine payment amount fields and for those not used, enter zeros. For example, if you are reporting on Form 1099-PATR, you will enter a "7" in tape position 22 of the "A" Record, Type of Return Indicator field. If you are reporting payments for Amount Codes 2, 4, and 7, then tape positions 23 through 31 of the "A" Record will be "247bbbbbb". In the Payee "B" Record, positions 51 through 60 for Payment Amount 1 will be zeros. Positions 61-70 will reflect the actual payment amount to be reported for "Nonpatronage distributions." Positions 71-80 for Payment Amount 3 will be zeros. Positions 81-90 will reflect the actual payment amount to be reported for "Federal income tax withheld." Positions 91-110 for Payment

Amounts 5 and 6 will be zeros. Positions 111-120 will reflect the actual payment amount to be reported for "Energy investment credit." Positions 121-140 for Payment Amounts 8 and 9 will be zeros. The First Payee Name Line will always appear in positions 162-201

.02 All records must be a fixed length. Records on magnetic media may be blocked or unblocked. Records may not span blocks. A block on magnetic media may not exceed 10,000 positions. DO NOT PAD A BLOCK WITH BLANKS. If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9s; however, the last block of the file may be filled with 9's or truncated.

.03 IRS must be able to identify the surname associated with the TIN (SSN or EIN) furnished on a statement. The specifications below include a field in the payee records called "Name Control" in which the first four alphabetic characters of the payee's surname or last name are to be entered by the payer. The surname or last name should appear first in the First Payee Name Line of all Payee "B" Records; however, if your records have been developed using the first name first, IRS programs will accept this but a blank must appear between the first and last name.

.04 If payers are unable to determine the first four characters of the surname, the Name Control Field may be left blank; however, compliance with the following will facilitate IRS computer programs in generating the Name Control.

(a) The surname of the payee whose TIN (SSN or EIN) is shown in the Payee "B" Record should always appear first. If, however, you enter the first name first, you must leave a blank space between the first and last name.

(b) In the case of multiple payees, only the surname of the payee whose TIN (SSN or EIN) is shown in the Payee "B" Record must be present in the First Payee Name Line. Surnames of any other payees in the record must be entered in the Second Payee Name Line.

.05 A field is also provided in these specifications for Special Data Entries. This field may be used to record information required by state or local governments or for the filer's own personal use. IRS does not use the data provided in the Special Data Entries field.

.06 Those filers participating in the Combined Federal/State Filing Program *must* code their records appropriately for the state to receive the information. *The state code now appears in tape positions 417 and 418 of the "B" Record.* The file should also meet the money criteria described in Part A, Sec. 12.11. Do not code for the states unless prior approval to participate has been granted by IRS. See Part A, Sec. 12.10 for a list of the valid participating state codes. FORMS 1098, 1099-A, 1099-B, *1099-S*, AND W-2G CANNOT BE FILED UNDER THE COMBINED FEDERAL/STATE FILING PROGRAM. Your files must meet all of the requirements specified in Part A, Sec. 12 in order to participate in this program.

.07 All alpha characters entered in the "B" Record should be uppercase.

.08 Do not use decimal points (.) to indicate dollars and cents on magnetic media.

.09 IRS STRONGLY ENCOURAGES FILERS TO REVIEW THEIR DATA FOR ACCURACY BEFORE SUBMISSION TO PREVENT ERRONEOUS NOTICES BEING MAILED TO PERSONS FOR WHOM REPORTS ARE FILED. FILERS SHOULD BE ESPECIALLY CAREFUL THAT THEIR TAXPAYER NAMES, SOCIAL SECURITY NUMBERS (SSNs), ACCOUNT NUMBERS, TYPES OF INCOME, AND INCOME AMOUNTS ARE CORRECT.

.10 WHEN REPORTING FORM 1098, MORTGAGE INTEREST STATEMENT, THE "A" RECORD WILL REFLECT THE NAME OF THE RECIPIENT OF THE INTEREST. THE "B" RECORD WILL REFLECT THE INDIVIDUAL PAYING THE INTEREST (THE BORROWER/PAYER OF RECORD) AND THE AMOUNT PAID. *FOR FORM 1099-S, THE "A" RECORD WILL REFLECT THE PERSON RESPONSIBLE FOR REPORTING THE TRANSACTION. THE "B" RECORD WILL REFLECT THE SELLER.*

RECORD NAME: PAYEE "B" RECORD

NOTE: For all fields marked REQUIRED, you must provide the information described under Description and Remarks. For those fields not marked REQUIRED, you must allow for the field but may be instructed to enter blanks or zeros in the indicated tape position(s) and for the indicated length. All records are now a fixed length of 420 positions.

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	REQUIRED. Enter "B".
2-3	Payment Year	2	REQUIRED. Must be the last two digits of the year for which payments are being reported (e.g., if payments were made in 1988 enter "88"). Must be incremented each year.
4-5	Document Specific Code	2	REQUIRED for Forms 1098, 1099-R, 1099-MISC, 1099-G, and W-2G. FOR ALL OTHER FORMS, *OR IF NOT USED*, ENTER BLANKS. *For Form 1098, position 4 will be used to indicate that the mortgage was incurred after 1987, position 5 will be blank.* For Form 1099-R, enter the appropriate code(s) for the Category of Distribution. More than one code may apply for Form 1099-R; however, if only one code is required, it will be entered in position 4 and position 5 will be blank. For Form 1099-MISC, position 4 is used to indicate Crop Insurance Proceeds, position 5 will be blank. For Form 1099-G, enter the year of income tax refund in position 4, position 5 will be blank. For Form W-2G enter the Type of Wager in position 4, position 5 will be blank.

Field Position	Field Title	Length	Description and Remarks
	Category of Distribution (Form 1099-R only)		Use only for reporting on Form 1099-R to identify the Category of Distribution. When applicable, you may enter a numeric and an alpha code but not two numeric codes. No numeric code is needed for normal distributions reported in Amount Code 1, but codes A, B, or C might apply. IRS suggests that anyone using code P *for the refund of an excess IRA contribution under Section 408(d)(4)* advise payees, at the time the distribution is made, that the earnings are taxable in the year in which the contribution was made. Enter the applicable code from the table that follows. A "0" (zero) is not a valid code for Form 1099-R. IF YOU ARE REPORTING A DISTRIBUTION TO WHICH THE FOLLOWING CODES DO NOT APPLY, ENTER BLANKS IN THIS FIELD. If you are reporting a total distribution from a plan that includes a distribution of a DEC, you must report two separate "B" Records—one to report the distribution of DECs and the other to report the distribution from the other part of the plan. This is necessary since DECs are not subject to 5-year/10-year averaging. Report the distribution of DECs in Amount Codes 1 and 2 of the "A" Record.

Category	*Code*
Premature distribution (other than codes 2, 3, 4, 5, 8, or P)	1
Rollover (*see NOTE 1*)	2
Disability	3
Death (includes payments to a beneficiary)	4
Prohibited transaction	5
Other (not including a normal distribution)	6
Normal IRA or SEP distributions	7
Excess contributions/*deferrals taxable in 1988* refunded plus earnings	8
PS 58 Costs (See NOTE 2)	9
Excess contributions/*deferrals* refunded plus earnings taxable in 1987	P
Qualifies for 5-year/10-year averaging	A
Qualifies for death benefit exclusion	B
Qualifies for *both* A and B	C

NOTE 1: Use this code only if the participant has informed you that the distribution will be rolled over and only if no other numeric code applies.

NOTE 2: PS 58 Costs may be reported on Form 1099-R if a total distribution is also made; otherwise, use Form W-2P (filed with SSA). *Since PS 58 costs are taxable as ordinary income,* a separate "B" Record is required to report PS 58 Costs. These costs may not be reported in combination with a total distribution. Refer to the 1988 "Instructions for Forms 1099, 1098, 5498, 1096, and W-2G," included in your magnetic media reporting packages.

Field Position	Field Title	Length	Description and Remarks
	Mortgage Incurred After 1987 (Form 1098 Only)		*If the mortgage was incurred after 1987, for a purpose other than the purchase of a personal residence, position 4 will be "1." If this is not the case, position 4 will be blank. Position 5 will be blank.*
	Crop Insurance Proceeds (Form 1099-MISC only)		If the payment amount reported for Amount Code 7 is crop insurance proceeds, enter a "1" in position 4. Position 5 will be blank.
	Refund is for Tax Year (Form 1099-G only)		Use only for reporting the tax year for which the refund was issued. Enter the NUMERIC year for which the refund was issued (i.e., for 1987, enter 7). However, if the payment amount for Amount Code 2, State or Local Income Tax Refunds, contains a refund, credit or offset that is attributable to an income tax that applies exclusively to income from a trade or business and is not of general application, then enter the ALPHA equivalent of the year for which the refund was issued, from the table below (i.e., for 1987, enter G). This code should appear in position 4. Position 5 will be blank.

Year for which Refund was Issued	*Alpha Equivalent**
1	A
2	B
3	C
4	D
5	E
6	F
7	G
8	H
9	I
0	J

*To be used for trade or business refunds only.

RECORD NAME: PAYEE "B" RECORD—Continued

<table>
<tr><th>Field Position</th><th>Field Title</th><th>Length</th><th>Description and Remarks</th></tr>
<tr><td></td><td>Type of Wager (Form W-2G only)</td><td></td><td>Use only for reporting the Type of Wager on Form W-2G. This code will appear in position 4. Position 5 will be blank.
<table>
<tr><th>Category</th><th>Code</th></tr>
<tr><td>Horse Race Track (or Off Track Betting of a Horse Track nature)</td><td>1</td></tr>
<tr><td>Dog Race Track (or Off Track Betting of a Dog Track nature)</td><td>2</td></tr>
<tr><td>Jai-alai</td><td>3</td></tr>
<tr><td>State Conducted Lottery</td><td>4</td></tr>
<tr><td>Keno</td><td>5</td></tr>
<tr><td>Casino Type Bingo. DO NOT use this code for any other type of Bingo winnings (i.e., Church, Fire Dept., etc.).</td><td>6</td></tr>
<tr><td>Slot Machines</td><td>7</td></tr>
<tr><td>Any other types of gambling winnings. This includes Church Bingo, Fire Dept. Bingo, unlabeled winnings, etc.</td><td>8</td></tr>
</table></td></tr>
<tr><td>6</td><td>Blank</td><td>1</td><td>Enter blank.</td></tr>
<tr><td>7</td><td>Blank or Corrected Return Indicator</td><td>1</td><td>Enter blank. Tape position 7 is used to indicate a corrected return. Refer to Part A, Sec. 8 for specific instructions on how to file corrected returns using magnetic media.</td></tr>
<tr><td>8-11</td><td>Name Control</td><td>4</td><td>Enter the first 4 letters of the surname of the payee. The surname of the person whose TIN is being reported in positions 15-23 of the "B" Record should be used to determine the Name Control. This is especially important in the case of trustee accounts. IF THE NAME THAT CORRESPONDS TO THE TIN IS NOT INCLUDED IN THE FIRST OR SECOND PAYEE NAME LINE, EVERY EFFORT SHOULD BE MADE TO DEVELOP THE CORRECT NAME CONTROL OF THE NAME THAT CORRESPONDS TO THE TIN. Surnames of less than four (4) letters should be left-justified, filling the unused positions with blanks. Special characters and imbedded blanks should be removed. In the case of a business, use the first significant word of the business name—i.e., words such as "a," "an" and "of" are not considered significant. Disregard the word "the" when it is the first word of the name, unless there are only two words in the name. IF THE NAME CONTROL IS NOT DETERMINABLE BY THE PAYER, LEAVE THIS FIELD BLANK. A dash (–) and ampersand (&) are the only acceptable special characters.

The following examples may be helpful to you in developing the Name Control:
<table>
<tr><th>Name</th><th>Control</th></tr>
<tr><td>John Brown</td><td>BROW</td></tr>
<tr><td>John A. Lee</td><td>LEE*</td></tr>
<tr><td>James P. En Sr.</td><td>EN*</td></tr>
<tr><td>John O'Neill</td><td>ONEI</td></tr>
<tr><td>Mary Van Buren</td><td>VANB</td></tr>
<tr><td>Juan De Jesus</td><td>DEJE</td></tr>
<tr><td>John A. El-Roy</td><td>EL-R</td></tr>
<tr><td>Mr. John Smith</td><td>SMIT</td></tr>
<tr><td>Joe McCarthy</td><td>MCCA</td></tr>
<tr><td>Pedro Torres-Lopes</td><td>TORR</td></tr>
<tr><td>Mark D'Allesandro</td><td>DALL</td></tr>
<tr><td>The First Bank</td><td>FIRS</td></tr>
<tr><td>The Hideaway</td><td>THEH</td></tr>
<tr><td>A & B Cafe</td><td>A&BC</td></tr>
</table>
*Name Controls of less than four (4) significant characters must be left-justified and blank filled.</td></tr>
<tr><td>12-13</td><td>Blank</td><td>2</td><td>Enter blanks.</td></tr>
</table>

RECORD NAME: PAYEE "B" RECORD—Continued

<table>
<tr><th>Field Position</th><th>Field Title</th><th>Length</th><th>Description and Remarks</th></tr>
<tr><td>14</td><td>Type of TIN</td><td>1</td><td>REQUIRED. This field is used to identify the Taxpayer Identification Number (TIN) in positions 15-23 as either an Employer Identification Number, a Social Security Number, or the reason no number is shown. Enter the appropriate code from the following table:
<table>
<tr><th><i>Type of TIN</i></th><th><i>TIN</i></th><th><i>Type of Account</i></th></tr>
<tr><td>1</td><td>EIN</td><td>A business or an organization</td></tr>
<tr><td>2</td><td>SSN</td><td>An individual</td></tr>
<tr><td>blank</td><td>N/A</td><td>If the type of TIN is undeterminable, enter a blank.</td></tr>
</table></td></tr>
<tr><td>15-23</td><td>Taxpayer Identification Number</td><td>9</td><td>REQUIRED. Enter the valid 9-digit Taxpayer Identification Number of the payee (SSN or EIN, as appropriate). If an identification number has been applied for but not received enter blanks. Refer to Part A, Sec. 9. DO NOT ENTER HYPHENS, ALPHA CHARACTERS, ALL 9s OR ALL ZEROS.</td></tr>
<tr><td>24-43</td><td>Payer's Account Number for Payee</td><td>20</td><td>The payer <i>should, whenever possible,</i> use this field to enter the payee's account number. The use of this item will facilitate easy reference to specific records, in the payer's file should any questions arise. DO NOT ENTER A TAXPAYER IDENTIFICATION NUMBER IN THIS FIELD. An account number can be any account number assigned by the payer to the payee (i.e., checking account, savings account, etc.). THIS NUMBER WILL HELP TO DISTINGUISH THE INDIVIDUAL PAYEE'S ACCOUNT WITH YOU AND SHOULD BE UNIQUE TO IDENTIFY THE SPECIFIC TRANSACTION MADE WITH THE ORGANIZATION SHOULD MULTIPLE RETURNS BE FILED FOR ONE PAYEE. This information will be particularly necessary if you need to file a corrected return. You are strongly encouraged to use this field. You may use any number that will help identify the particular transaction that you are reporting. If fewer than twenty characters are required, right-justify filling the remaining positions with blanks.</td></tr>
<tr><td>44-46</td><td><i>Percentage of Total Distribution</i></td><td>3</td><td><i>THIS FIELD IS ONLY USED WHEN REPORTING FORMS 1099-R. If a total distribution is made to more than one person, enter the percentage received by the person whose TIN is included in positions 15-23 of the "B" Record. Field must be right-justified, and unused positions must be zero filled. If not applicable, enter blanks.</i></td></tr>
<tr><td>47-50</td><td>Blank</td><td>4</td><td>Enter blanks.</td></tr>
<tr><td></td><td>Payment Amount Fields (Must be numeric)</td><td></td><td>REQUIRED. All records submitted in this program must be a fixed length of 420 positions. You must allow for all payment amounts and for those not used you will enter zeros. For example: If position 22 of the Payer/Transmitter "A" Record is "7" (for 1099-PATR) and positions 23-31 are "247bbbbbb", this indicates that you will be reporting 3 actual payment amounts in all of the following Payee "B" Records. Payment Amount 1 will be all "0" (zeros), Payment Amount 2 will represent Nonpatronage distributions, Payment Amount 3 will be all "0" (zeros), Payment Amount 4 will represent Federal income tax withheld, Payment Amounts 5 and 6 will be all "0" (zeros), Payment Amount 7 will represent Energy investment credit, and Payment Amounts 8 and 9 will be all "0" (zeros). Each payment field must contain 10 numeric characters (see NOTE 1).

Each payment amount must be entered in U.S. dollars and cents. <i>The rightmost two positions represent cents in the Payment Amount Fields.</i> Do not enter dollar signs, commas, decimal points, or NEGATIVE PAYMENTS (except those items that reflect a loss on Form 1099-B). <i>Positive and negative amounts are indicated by placing a "+" or "-" (minus sign) in the left most position of the payment amount field. A negative overpunch in the units position may be used, instead of a minus sign, to indicate a negative amount. If a plus sign, minus sign, or negative overpunch is not used, the number will be assumed to be positive.</i> PAYMENT AMOUNTS MUST BE RIGHT-JUSTIFIED AND UNUSED POSITIONS MUST BE ZERO FILLED. Federal income tax withheld is not reported as a negative amount for any form.</td></tr>
</table>

RECORD NAME: PAYEE "B" RECORD—Continued

Field Position	Field Title	Length	Description and Remarks
			NOTE 1: If any one payment amount exceeds "9999999999" (dollars and cents), as many SEPARATE Payee "B" Records as necessary to contain the total amount MUST be submitted for the Payee. NOTE 2: If you file 1099-MISC and you are reporting a direct sale of $5,000 or more, enter 0000000100 in Payment Amount 9. This will not represent an actual money amount; this is an indicator of direct sales. (Refer to Part B, Sec. 4, NOTE 3, of the Amount Indicators, Form 1099-MISC, for clarification.)
51-60	Payment Amount 1	10	The amount reported in this field represents payments for Amount Code 1 in the Payer/Transmitter "A" Record.
61-70	Payment Amount 2	10	The amount reported in this field represents payments for Amount Code 2 in the Payer/Transmitter "A" Record.
71-80	Payment Amount 3	10	The amount reported in this field represents payments for Amount Code 3 in the Payer/Transmitter "A" Record.
81-90	Payment Amount 4	10	The amount reported in this field represents payments for Amount Code 4 in the Payer/Transmitter "A" Record.
91-100	Payment Amount 5	10	The amount reported in this field represents payments for Amount Code 5 in the Payer/Transmitter "A" Record.
101-110	Payment Amount 6	10	The amount reported in this field represents payments for Amount Code 6 in the Payer/Transmitter "A" Record.
111-120	Payment Amount 7	10	The amount reported in this field represents payments for Amount Code 7 in the Payer/Transmitter "A" Record.
121-130	Payment Amount 8	10	The amount reported in this field represents payments for Amount Code 8 in the Payer/Transmitter "A" Record.
131-140	Payment Amount 9	10	The amount reported in this field represents payments for Amount Code 9 in the Payer/Transmitter "A" Record.
141-160	Blank	20	Enter blanks.
161	Foreign Country Indicator	1	REQUIRED. If the payee address is in a foreign country enter a "1" in this field. This will allow you to use any format for the Payee Address, City, State, and ZIP Code. Address information must not appear in the First or Second Payee Name Lines. If the address for the payee is a U.S. address, you must enter a blank in this field. The free address format may only be used for foreign addresses. For U.S. addresses, you must use the U.S. Postal Service state abbreviations in magnetic media positions 311 and 312. These abbreviations are provided in Part A, Sec. 14.
162-201	First Payee Name Line	40	REQUIRED. The First Payee Name Line will always appear in positions 162-201. Do not enter address information in this field. Enter the name of the payee (preferably surname first) whose Taxpayer Identification Number appears in positions 15-23 above. If fewer than 40 characters are required, left-justify and fill unused positions with blanks. If more space is required for the name, utilize the Second Payee Name Line field below. If there are multiple payees, only the name of the payee whose Taxpayer Identification Number has been provided should be entered in this field. The names of the other payees should be entered in the Second Payee Name Line field. NOTE: WHEN REPORTING FORM 1098, MORTGAGE INTEREST STATEMENT, THE "A" RECORD WILL REFLECT THE NAME OF THE RECIPIENT OF THE INTEREST (*THE FILER*). THE "B" RECORD WILL REFLECT THE INDIVIDUAL PAYING THE INTEREST (*THE BORROWER/PAYER OF RECORD*) AND THE AMOUNT PAID. *FOR FORMS 1099-S, THE "B" RECORD WILL REFLECT THE SELLER INFORMATION.*

RECORD NAME: PAYEE "B" RECORD—Continued

Field Position	Field Title	Length	Description and Remarks
202–241	Second Payee Name Line	40	If the payee name requires more space than is available in the First Payee Name Line, enter only the remaining portion of the name in this field. If there are multiple payees, (e.g., partners or joint owners) this field may be used for those payees' names who are not associated with the Taxpayer Identification Number provided in positions 15–23 above. Do not enter address information in this field. Left-justify and fill unused positions with blanks. FILL WITH BLANKS IF NO ENTRIES ARE PRESENT FOR THIS FIELD.
242–281	Payee Mailing Address	40	REQUIRED. Enter mailing address of payee. Left-justify and fill unused positions with blanks. The address MUST be present. This field MUST NOT contain any data other than the payee's mailing address.

For U.S. addresses, the Payee City, Payee State and Payee Zip Code must be reported as a 29, 2, and 9 position field, respectively. For foreign addresses, the Payee City, Payee State and Payee Zip Code can be reported as a continuous 40 position field. When reporting a foreign address, the Foreign Country Indicator must contain a "1."

Field Position	Field Title	Length	Description and Remarks
282–310	Payee City	29	REQUIRED. Enter the city, left-justified and fill the unused positions with blanks. Do not enter state and ZIP Code information in this field.
311–312	Payee State	2	REQUIRED. Enter the abbreviation for the state as shown in Part A, Sec. 14. You MUST use valid U.S. Postal Service state abbreviations for U.S. addresses.
313–321	Payee ZIP Code	9	REQUIRED. Enter the valid 9 digit ZIP Code assigned by the U.S. Postal Service. If only the first 5 digits are known, left-justify and fill the unused positions with blanks. Use this field for the ZIP Code only. For foreign countries, alpha characters are acceptable as long as you have entered a "1" in position "161" of the Foreign Country Indicator field.

THE FOLLOWING FIELD DEFINITIONS DESCRIBE PAYEE "B" RECORD POSITIONS FOLLOWING THE PAYEE ZIP CODE FOR EITHER (1) FORMS 1098, 1099–DIV, 1099–G, 1099–INT, 1099–MISC, 1099–PATR, 1099–R AND 5498 OR (2) FORM 1099–A OR (3) FORM 1099–B OR (4) FORM 1099–OID, OR (5) Form 1099–S, OR (6) FORM W–2G.

(1) FORMS 1098, 1099–DIV, 1099–G, 1099–INT, 1099–MISC, 1099–PATR, 1099–R, and 5498

NEXT FIELD AFTER PAYEE ZIP CODE:

Field Position	Field Title	Length	Description and Remarks
322–349	Blank	28	Enter blanks.
350–416	Special Data Entries	67	This portion of the Payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for their filing requirements. If this field is not utilized, ENTER BLANKS.
417–418	State Code	2	If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 12.10. For those filers or states NOT participating in this program or for Form 1098, ENTER BLANKS.
419–420	Blank	2	Enter blanks.

PAYEE "B" RECORD—RECORD LAYOUT
FORMS 1098, 1099–DIV, 1099–G, 1099–INT, 1099–MISC, 1099–PATR, 1099–R and 5498

RECORD TYPE	PAYMENT YEAR	DOCUMENT SPECIFIC CODE	BLANK	BLANK OR CORRECTED RETURN INDICATOR	NAME CONTROL *	BLANK	TYPE OF TIN *	TAXPAYER IDENTIFICATION NUMBER *
1	2–3	4–5	6	7	8–11	12–13	14	15–23

PAYEE "B" RECORD—RECORD LAYOUT
FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R and 5498—Continued

PAYER'S ACCOUNT NUMBER FOR PAYEE*	PERCENTAGE OF TOTAL DISTRIBUTION	BLANK	PAYMENT AMOUNT 1	PAYMENT AMOUNT 2	PAYMENT AMOUNT 3
24–43	44–46	47–50	51–60	61–70	71–80

PAYMENT AMOUNT 4	PAYMENT AMOUNT 5	PAYMENT AMOUNT 6	PAYMENT AMOUNT 7	PAYMENT AMOUNT 8	PAYMENT AMOUNT 9
81–90	91–100	101–110	111–120	121–130	131–140

BLANK	FOREIGN COUNTRY INDICATOR	FIRST PAYEE NAME LINE*	SECOND PAYEE NAME LINE*	PAYEE MAILING ADDRESS*	PAYEE CITY*	PAYEE STATE*
141–160	161	162–201	202–241	242–281	282–310	311–312

PAYEE ZIP CODE*	BLANK	SPECIAL DATA ENTRIES	STATE CODE	BLANK
313–321	322–349	350–416	417–418	419–420

* When reporting Form 1098, Mortgage Interest Statement, the "B" record will reflect the individual paying the interest *(the borrower/payer of record)* and the amount paid. *For Forms 1099-S, the "B" Record will reflect the seller information.*

RECORD NAME: PAYEE "B" RECORD—Continued

Field Position	Field Title	Length	Description and Remarks
(2) FORM 1099-A (For detailed explanations of the following fields, see the 1988 "Instructions for Forms 1099, 1098, 5498, 1096, and W-2G," included in your magnetic media reporting packages.)			
NEXT FIELD AFTER PAYEE ZIP CODE:			
322-349	Blank	28	Enter blanks.
350-370	Special Data Entries	21	This portion of the Payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for their filing requirements. If this field is not utilized, ENTER BLANKS.
371-376	Date of Lender's Acquisition or Knowledge of Abandonment	6	REQUIRED FOR FORM 1099-A ONLY. Enter the date of your acquisition of the secured property or the date you first knew or had reason to know that the property was abandoned in the format MMDDYY. DO NOT ENTER HYPHENS OR SLASHES.
377	Liability Indicator	1	REQUIRED FOR FORM 1099-A ONLY. Enter the appropriate indicator from table below: *Indicator* — *Usage* 1 — Borrower is personally liable for repayment of the debt. Blank — Borrower is not liable for repayment of the debt.

RECORD NAME: PAYEE "B" RECORD—Continued

Field Position	Field Title	Length	Description and Remarks
378-416	Description	39	REQUIRED FOR FORM 1099-A ONLY. Enter a brief description of the property. For example, for real property, enter the address, or if the address does not sufficiently identify the property, enter the section, lot and block. For personal property, enter the type, make and model (e.g., Car—1987 Buick Regal or Office Equipment). *Enter "CCC" for crops forfeited on Commodity Credit Corporation loans.* If fewer than 39 positions are required, left-justify and fill unused positions with blanks.
417-420	Blank	4	Enter blanks.

PAYEE "B" RECORD—RECORD LAYOUT
FORM 1099-A

RECORD TYPE	PAYMENT YEAR	BLANK	BLANK OR CORRECTED RETURN IND.	NAME CONTROL	BLANK	TYPE OF TIN	TAXPAYER IDENTIFICATION NUMBER
1	2-3	4-6	7	8-11	12-13	14	15-23

PAYER'S ACCOUNT NUMBER FOR PAYEE	BLANK	PAYMENT AMOUNT 1	PAYMENT AMOUNT 2	PAYMENT AMOUNT 3	PAYMENT AMOUNT 4
24-43	44-50	51-60	61-70	71-80	81-90

PAYMENT AMOUNT 5	PAYMENT AMOUNT 6	PAYMENT AMOUNT 7	PAYMENT AMOUNT 8	PAYMENT AMOUNT 9	BLANK
91-100	101-110	111-120	121-130	131-140	141-160

FOREIGN COUNTRY INDICATOR	FIRST PAYEE NAME LINE	SECOND PAYEE NAME LINE	PAYEE MAILING ADDRESS	PAYEE CITY	PAYEE STATE	PAYEE ZIP CODE
161	162-201	202-241	242-281	282-310	311-312	313-321

BLANK	SPECIAL DATA ENTRIES	DATE OF LENDER'S ACQUISITION OR ABANDONMENT	LIABILITY INDICATOR	DESCRIPTION	BLANK
322-349	350-370	371-376	377	378-416	417-420

RECORD NAME: PAYEE "B" RECORD—Continued

Field Position	Field Title	Length	Description and Remarks
(3) FORM 1099-B (For detailed explanations of the following fields see the 1988 "Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.")			
NEXT FIELD AFTER PAYEE ZIP CODE:			
322-349	Blank	28	Enter blanks.
350-359	Special Data Entries	10	This portion of the Payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for their filing requirements. If this field is not utilized, ENTER BLANKS.
360	Gross Proceeds Indicator	1	REQUIRED FOR FORM 1099-B ONLY. Enter appropriate indicator from table below. If this field is not utilized, ENTER BLANKS. *Indicator* — *Usage* 1 — Gross proceeds 2 — Gross proceeds less commissions and option premiums
361-366	Date of Sale	6	REQUIRED FOR FORM 1099-B ONLY. Enter the trade date of the transaction in the format MMDDYY. Enter blanks if this is an aggregate transaction. DO NOT ENTER HYPHENS OR SLASHES.
367-379	CUSIP No.	13	REQUIRED FOR FORM 1099-B ONLY. Enter the CUSIP (Committee on Uniform Security Identification Procedures) number of the items reported for Amount Indicator "2" (Stocks, bonds, etc.). Enter blanks if this is an aggregate transaction. Enter "0" (zeros) if the number is not available. For CUSIP numbers with less than 13 characters, right-justify and fill the remaining positions with blanks.
380-418	Description	39	REQUIRED FOR FORM 1099-B ONLY. Enter a brief description of the item or services for which the proceeds are being reported. If fewer than 39 characters are required, left-justify and fill unused positions with blanks. For regulated futures contracts, enter "RFC" and any amount subject to backup withholding. Enter blanks if this is an aggregate transaction.
419-420	Blank	2	Enter blanks.

PAYEE "B" RECORD—RECORD LAYOUT
FORM 1099-B

RECORD TYPE	PAYMENT YEAR	BLANK	BLANK OR CORRECTED RETURN IND.	NAME CONTROL	BLANK	TYPE OF TIN	TAXPAYER IDENTIFICATION NUMBER
1	2–3	4–6	7	8–11	12–13	14	15–23

PAYER'S ACCOUNT NUMBER FOR PAYEE	BLANK	PAYMENT AMOUNT 1	PAYMENT AMOUNT 2	PAYMENT AMOUNT 3	PAYMENT AMOUNT 4
24–43	44–50	51–60	61–70	71–80	81–90

PAYMENT AMOUNT 5	PAYMENT AMOUNT 6	PAYMENT AMOUNT 7	PAYMENT AMOUNT 8	PAYMENT AMOUNT 9	BLANK
91–100	101–110	111–120	121–130	131–140	141–160

PAYEE "B" RECORD–RECORD LAYOUT
FORM 1099-B–Continued

FOREIGN COUNTRY INDICATOR	FIRST PAYEE NAME LINE	SECOND PAYEE NAME LINE	PAYEE MAILING ADDRESS	PAYEE CITY	PAYEE STATE	PAYEE ZIP CODE
161	162–201	202–241	242–281	282–310	311–312	313–321

BLANK	SPECIAL DATA ENTRIES	GROSS PROCEEDS INDICATOR	DATE OF SALE	CUSIP NUMBER
322–349	350–359	360	361–366	367–379

DESCRIPTION	BLANK
380–418	419–420

RECORD NAME: PAYEE "B" RECORD–Continud

(4) FORM 1099–OID (For detailed explanations of the following fields see the 1988 "Instructions for Forms 1099, 1098, 5498, 1096, and W-2G,"

NEXT FIELD AFTER PAYEE ZIP CODE:

Field Position	Field Title	Length	Description and Remarks
322–349	Blank	28	Enter blanks.
350–377	Special Data Entries	28	This portion of the Payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for their filing requirements. If this field is not utilized, ENTER BLANKS.
378–416	Description	39	REQUIRED FOR FORM 1099–OID ONLY. Enter a brief description of the *obligation* for which the proceeds are being reported. *The description may include the stock exchange, issuer, coupon rate, and year of maturity.* If fewer than 39 characters are required, left-justify and fill unused positions with blanks.
417–418	State Code	2	If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 12.10. For those filers or states NOT participating in this program, ENTER BLANKS.
419–420	Blank	2	Enter blanks.

PAYEE "B" RECORD–RECORD LAYOUT FORM 1099–OID

RECORD TYPE	PAYMENT YEAR	BLANK	BLANK OR CORRECTED RETURN IND.	NAME CONTROL	BLANK	TYPE OF TIN	TAXPAYER IDENTIFICATION NUMBER
1	2–3	4–6	7	8–11	12–13	14	15–23

PAYER'S ACCOUNT NUMBER FOR PAYEE	BLANK	PAYMENT AMOUNT 1	PAYMENT AMOUNT 2	PAYMENT AMOUNT 3	PAYMENT AMOUNT 4
24–43	44–50	51–60	61–70	71–80	81–90

PAYEE "B" RECORD—RECORD LAYOUT FORM 1099-OID—Continued

PAYMENT AMOUNT 5	PAYMENT AMOUNT 6	PAYMENT AMOUNT 7	PAYMENT AMOUNT 8	PAYMENT AMOUNT 9	BLANK
91–100	101–110	111–120	121–130	131–140	141–160

FOREIGN COUNTRY INDICATOR	FIRST PAYEE NAME LINE	SECOND PAYEE NAME LINE	PAYEE MAILING ADDRESS	PAYEE CITY	PAYEE STATE	PAYEE ZIP CODE
161	162–201	202–241	242–281	282–310	311–312	313–321

BLANK	SPECIAL DATA ENTRIES	DESCRIPTION	COMBINED FEDERAL STATE CODE	BLANK
322–349	350–377	378–416	417–418	419–420

RECORD NAME: PAYEE "B" RECORD—Continued

Field Position	Field Title	Length	Description and Remarks
(5) FORM 1099–S (for detailed explanation of the following fields see the 1988 "Instructions for Forms 1099, 1098, 5498, 1096 and W-2G," included in your magnetic media reporting packages.)			
			NEXT FIELD AFTER PAYEE ZIP CODE:
322–349	Blank	28	Enter blanks.
350–372	Special Data Entries	23	This portion of the Payee "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact their state or local revenue departments for their filing requirements. If this field is not utilized, enter blanks.
373–378	Date of Closing	6	REQUIRED FOR FORM 1099–S ONLY. Enter the closing date in the format MMDDYY. Do not' enter hyphens or slashes.
379–417	Description	39	REQUIRED FOR FORM 1099–S ONLY. Enter the address of the property transferred or a legal description of the property. If fewer than 39 positions are required, left-justify and fill unused positions with blanks.
418	Property or Services Received	1	REQUIRED FOR FORM 1099–S ONLY. If the transferor received or will receive property (other than cash) or services as part of the consideration for the property transferred, enter "1." If this field is not utilized, enter blanks.
419–420	Blank	2	Enter blanks.

PAYEE "B" RECORD—RECORD LAYOUT FORM 1099–S

RECORD TYPE	PAYMENT YEAR	BLANK	BLANK OR CORRECTED RETURN IND.	NAME CONTROL	BLANK	TYPE OF TIN	TAXPAYER IDENTIFICATION NUMBER
1	2–3	4–6	7	8–11	12–13	14	15–23

PAYEE "B" RECORD—RECORD LAYOUT FORM 1099-S—Continued

PAYER'S ACCOUNT NUMBER FOR PAYEE	BLANK	PAYMENT AMOUNT 1	PAYMENT AMOUNT 2	PAYMENT AMOUNT 3	PAYMENT AMOUNT 4
24–43	44–50	51–60	61–70	71–80	81–90

PAYMENT AMOUNT 5	PAYMENT AMOUNT 6	PAYMENT AMOUNT 7	PAYMENT AMOUNT 8	PAYMENT AMOUNT 9	BLANK
91–100	101–110	111–120	121–130	131–140	141–160

FOREIGN COUNTRY INDICATOR	FIRST PAYEE NAME LINE	SECOND PAYEE NAME LINE	PAYEE MAILING ADDRESS	PAYEE CITY	PAYEE STATE	PAYEE ZIP CODE
161	162–201	202–241	242–281	282–310	311–312	313–321

BLANK	SPECIAL DATA ENTRIES	DATE OF CLOSING	DESCRIPTION	PROPERTY OR SERVICES RECEIVED	BLANK
322–349	350–372	373–378	379–417	418	419–420

(6) FORM W-2G (For detailed explanations of the following fields see the 1988 "Instructions for Forms 1099, 1098, 5498, 1096, and W-2G," included in your magnetic media reporting packages.)

NEXT FIELD AFTER PAYEE ZIP CODE:

Field Position	Field Title	Length	Description and Remarks
322–352	Blank	31	Enter blanks.
353–358	Date Won	6	REQUIRED FOR FORM W-2G ONLY. Enter the date of the winning event in MMDDYY format. This is not the date the money was paid, if paid after the date of the race (or game). DO NOT ENTER HYPHENS OR SLASHES.
359–373	Transaction	15	REQUIRED FOR FORM W-2G ONLY. If applicable, the ticket number, card number (and color, if applicable), machine serial number, or any other information that will help identify the winning transaction. If no entry, enter blanks. Not applicable for horse and dog racing, jai-alai, and certain other wagering transactions, sweepstakes, wagering pools, and certain lotteries.
374–378	Race	5	REQUIRED FOR FORM W-2G ONLY. The race (or game) applicable to the winning ticket. If no entry, enter blanks.
379–383	Cashier	5	REQUIRED FOR FORM W-2G ONLY. If applicable, the initials of the cashier and/or the window number making the winning payment. If no entry, enter blanks.
384–388	Window	5	REQUIRED FOR FORM W-2G ONLY. If applicable, the location of the person paying the winnings. If no entry, enter blanks.
389–403	First ID	15	REQUIRED FOR FORM W-2G ONLY. If applicable, the first identification number of the person receiving the winnings. If no entry, enter blanks.
404–418	Second ID	15	REQUIRED FOR FORM W-2G ONLY. If applicable, the second identification number of the person receiving the winnings. If no entry, enter blanks.
419–420	Blank	2	REQUIRED. Enter blanks.

PAYEE B" RECORD–RECORD LAYOUT FORM W-2G

RECORD TYPE	PAYMENT YEAR	DOCUMENT SPECIFIC CODE	BLANK	BLANK OR CORRECTED RETURN IND.	NAME CONTROL	BLANK	TYPE OF TIN
1	2–3	4	5–6	7	8–11	12–13	14

TAXPAYER IDENTIFICATION NUMBER	PAYER'S ACCOUNT NUMBER FOR PAYEE	BLANK	PAYMENT AMOUNT 1	PAYMENT AMOUNT 2	PAYMENT AMOUNT 3
15–23	24–43	44–50	51–60	61–70	71–80

PAYMENT AMOUNT 4	PAYMENT AMOUNT 5	PAYMENT AMOUNT 6	PAYMENT AMOUNT 7	PAYMENT AMOUNT 8	PAYMENT AMOUNT 9	BLANK
81–90	91–100	101–110	111–120	121–130	131–140	141–160

FOREIGN COUNTRY INDICATOR	FIRST PAYEE NAME LINE	SECOND PAYEE NAME LINE	PAYEE MAILING ADDRESS	PAYEE CITY	PAYEE STATE	PAYEE ZIP CODE
161	162–201	202–241	242–281	282–310	311–312	313–321

BLANKS	DATE WON	TRANSACTION	RACE	CASHIER
322–352	353–358	359–373	374–378	379–383

WINDOW	FIRST ID	SECOND ID	BLANK
384–388	389–403	404–418	419–420

Section 7. End of Payer "C" Record

.01 THE "C" RECORD IS A FIXED RECORD LENGTH OF 420 POSITIONS. The Control Total fields are each 15 positions in length.

.02 The End of Payer "C" Record is a summary record for a type of return for a given payer.

.03 The "C" Record will contain the total number of payees and the totals of the payment amount fields filed by a given payer. The "C" Record must be written after the last Payee "B" Record for each type of return for a given payer. For each "A" Record and group of "B" Records on the file, there must be a corresponding "C" Record.

.04 In developing the "C" Record, for example, if you used Amount Codes 1, 3 and 6 in the "A" Record, the totals from the "B" Records will appear in Control Totals 1, 3 and 6 of the "C" Record. In this example, positions 26–40, 56–85, and 101–145 would be zero filled. Positions 146–420 would be blank filled.

.05 Payers/Transmitters must verify the accuracy of the totals in the "C" Record and must enter the totals on the transmittal, Form 4804, 4802 or computer generated substitute, which will accompany the shipment. The lines used on Forms 4804 and 4802 to record payment amounts correspond with the Amount Codes used in the "A" Record.

RECORD NAME: END OF PAYER "C" RECORD

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	REQUIRED. Enter "C".
2-7	Number of Payees	6	REQUIRED. Enter the total number of Payee "B" Records covered by the preceding Payer/Transmitter "A" Record. Right-justify and zero fill.
8-10	Blank	3	Enter blanks.
	REQUIRED. If any corresponding Payment Amount fields are present in the Payee "B" Records, accumulate into the appropriate Control Total field. RIGHT JUSTIFY AND ZERO FILL UNUSED CONTROL TOTAL FIELDS. Please note that all Control Total fields are 15 positions in length.		
11-25	Control Total 1	15	
26-40	Control Total 2	15	
41-55	Control Total 3	15	
56-70	Control Total 4	15	
71-85	Control Total 5	15	
86-100	Control Total 6	15	
101-115	Control Total 7	15	
116-130	Control Total 8	15	
131-145	Control Total 9	15	
146-420	Blank	275	Enter blanks.

END OF PAYER "C" RECORD–RECORD LAYOUT

RECORD TYPE	NUMBER OF PAYEES	BLANK	CONTROL TOTAL 1	CONTROL TOTAL 2	CONTROL TOTAL 3	CONTROL TOTAL 4
1	2-7	8-10	11-25	26-40	41-55	56-70

CONTROL TOTAL 5	CONTROL TOTAL 6	CONTROL TOTAL 7	CONTROL TOTAL 8	CONTROL TOTAL 9	BLANK
71-85	86-100	101-115	116-130	131-145	146-420

Section 8. State Totals "K" Record

.01 THE "K" RECORD IS A FIXED RECORD LENGTH OF 420 POSITIONS. The Control Total fields are each 15 positions in length.

.02 The State Totals "K" Record is a summary for a given payer and a given state in the Combined Federal/State Filing Program, used ONLY when state reporting approval has been granted. ALL RECORDS ARE A FIXED LENGTH OF 420 POSITIONS.

.03 The "K" Record will contain the total number of payees and the totals of the payment amount fields filed by a given payer for a given state. The "K" Record(s) must be written after the "C" Record for the related "A" Record.

.04 *In developing the "K" Record, for example, if you used Amount Codes 1, 3 and 6 in the "A" Record, the totals from the "B" Records coded for this state will appear in Control Totals 1, 3 and 6 of the "K" Record.*

.05 There MUST be a separate "K" Record for each state being reported.

.06 Refer to Part A, Sec. 12 for the requirements and conditions that MUST be met to file on this program.

RECORD NAME: STATE TOTALS "K" RECORD

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	REQUIRED. Enter "K".
2-7	Number of Payees	6	REQUIRED. Enter the total number of Payee "B" Records being coded for this state. Right-justify and zero fill.
8-10	Blank	3	Enter blanks.
	REQUIRED. If any corresponding Payment Amount fields are present in the Payee "B" Records, accumulate into the appropriate Control Total field. RIGHT JUSTIFY AND ZERO FILL UNUSED CONTROL TOTAL FIELDS. Please note that all Control Total fields are 15 positions in length.		
11-25	Control Total 1	15	
26-40	Control Total 2	15	
41-55	Control Total 3	15	
56-70	Control Total 4	15	
71-85	Control Total 5	15	
86-100	Control Total 6	15	
101-115	Control Total 7	15	
116-130	Control Total 8	15	
131-145	Control Total 9	15	
146-416	Reserved	271	Reserved for IRS use. Enter blanks.
417-418	State Code	2	REQUIRED. Enter the code assigned to the state which is to receive the information. Refer to Part A, Sec. 12.10.
419-420	Blank	2	Enter blanks.

STATE TOTALS "K" RECORD—RECORD LAYOUT

RECORD TYPE	NUMBER OF PAYEES	BLANK	CONTROL TOTAL 1	CONTROL TOTAL 2	CONTROL TOTAL 3	CONTROL TOTAL 4
1	2-7	8-10	11-25	26-40	41-55	56-70

CONTROL TOTAL 5	CONTROL TOTAL 6	CONTROL TOTAL 7	CONTROL TOTAL 8	CONTROL TOTAL 9	RESERVED	STATE CODE
71-85	86-100	101-115	116-130	131-145	146-416	417-418

BLANK
419-420

Section 9. End of Transmission "F" Record

.01 THE "F" RECORD IS A FIXED RECORD LENGTH OF 420 POSITIONS. The "F" Record is a summary of the number of payers in the entire file.

.02 This record should be written after the last "C" Record (or "K" Record, when applicable) of the entire file.

RECORD NAME: END OF TRANSMISSION "F" RECORD

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	REQUIRED. Enter "F".
2-5	Number of "A" Records	4	You may enter the total number of Payer/Transmitter "A" Records in this transmission. Right-justify and zero fill or enter all zeros.
6-30	Zero	25	Enter zeros.
31-420	Blank	390	Enter blanks.

END OF TRANSMISSION "F" RECORD—RECORD LAYOUT

RECORD TYPE	NUMBER OF "A" RECORDS	ZEROS	BLANK
1	2-5	6-30	31-420

CONTENTS

EE-129-86 880
EE-162-86 880
EE-167-86 881
EE-184-86 881
INTL-52-86 892
INTL-932-86 915
INTL-941-86 916
INTL-990-86 916
INTL-128-87 917
INTL-313-87 920
INTL-491-87 921
INTL-905-87 922
LR-17-86 923
LR-97-86 923
LR-101-86 924
LR-114-86 925
LR-128-86 925
LR-137-86 926
LR-29-87 927
LR-39-87 927
LR-45-87 929
LR-55-87 929
LR-65-87 930
LR-83-87 930
LR-14-88 932
LR-26-88 933
LR-28-88 933
LR-29-88 934
LR-47-88 935
LR-53-88 935

The "Proposed regulations" heading in the index contains a list of Code sections affected, the subject matter, and the "LR" "INTL" or "EE" number and page.

Notice of Proposed Rulemaking

Definitions of "Highly Compensated Employee" and "Compensation"

EE-129-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: ***, the Internal Revenue Service is issuing temporary regulations [page 134, this Bulletin] relating to the scope and meaning of the terms "highly compensated employee" in section 414(q) and "compensation" in section 414(s) of the internal Revenue Code of 1986. They reflect changes made by the Tax Reform Act of 1986 (TRA '86). The text of those temporary regulations also serves as the text for this Notice of Proposed Rulemaking. These regulations will provide the public with guidance necessary to comply with the law and would affect sponsors of, and participants in, pension, profit-sharing and stock bonus plans, and certain other employee benefit plans.

DATES: Written comments and requests for a public hearing must be delivered or mailed by April 19, 1988. In general, these regulations apply to years beginning on or after January 1, 1987, except as otherwise specified in TRA '86.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (EE-129-86) Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION

BACKGROUND

The temporary regulations *** [page 134, this Bulletin] amend 26 CFR by adding a new section 1.414(q)-1T under Part 1 to provide guidance with respect to the definitions of highly compensated employee and compensation within the meaning of Code section 414(q) and (s). The regulations are proposed to be issued under the authority contained in sections 414(s) and 7805 of the Code (100 Stat. 2453, 68A Stat. 917; 26 U.S.C. 414(s), 7805). For the text of the temporary regulations, *** [T.D. 8173, page 134, this Bulletin].

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis is not required.

Although this document is a notice of proposed rulemaking which solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

LIST OF SUBJECTS IN 26 CFR 1.401-0—1.425-1

Income taxes, Employee benefit plans, Pensions.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on February 18, 1988, 8:45 a.m., and published in the issue of the Federal Register for February 19, 1988, 53 F.R. 4999)

Notice of Proposed Rulemaking

Excise Tax on Excess Distributions From Retirement Plans

EE-162-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: *** [page 365, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to the excise tax on excess distributions from retirement plans under section 1133 of the Tax Reform Act of 1986. The text of those temporary regulations also serves as the text for this Notice of Proposed Rulemaking.

DATES: Written comments and requests for a public hearing must be delivered or mailed before February 8, 1988.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (EE-162-86), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary regulations *** [page 365, this Bulletin], amend 26 CFR by adding a new section 54.4981A-1T under Part 54 to provide guidance so taxpayers can comply with section 4981A of the Internal Revenue Code. The final regulations which are proposed to be based on the temporary regulations would amend Part 54 of Title 26 of the Code of Federal Regulations by adding similar sections to Part 54 (Pension Excise Tax Regulations). The regulations are proposed to be issued under the authority contained in sections 4981A and 7805 of the Code (100 Stat. 2481, 26 U.S.C. 4981A; 68A Stat. 917, 26 U.S.C. 7805). For the text of the temporary regulations, see F.R. Doc. (T.D. 8165) *** [page 365, this Bulletin].

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. Although this document is a notice of proposed rulemaking which solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUEST FOR PUBLIC HEARING.

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably 8 copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register. The collection of information requirements contained herein have been submitted to the Office of Management and Budget (OMB) for review under section 3504(h) of the Paperwork Reduction Act. Comments on the requirements should be sent to the Office of Information and Regulatory Affairs of OMB, Attention: Desk Officer for the Internal Revenue Service, New Executive Office Building, Washington, D.C. 20503. The Internal Revenue Service requests persons submitting comments to OMB also to send copies of the comments to the Service.

* * * * *

Lawrence B. Gibbs,
Commissioner of
Internal Revenue

(Filed by the Office of the Federal Register on December 9, 1987, 8:45 a.m., and published in the issue of the Federal Register for December 10, 1987, 52, F.R. 46782

Notice of Proposed Rulemaking

Minimum Vesting Standards

EE-167-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross reference to temporary regulations.

SUMMARY: This document provides proposed regulations relating to the minimum vesting standards for qualified employee plans. Changes to the applicable laws were made by the Tax Reform Act of 1986. These proposed regulations amend the current regulations to reflect the changes. *** [T]he Internal Revenue Service is issuing temporary regulations [page 118, this Bulletin] relating to the minimum vesting standards. The text of these temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: Written comments and requests for a public hearing must be delivered or mailed by March 7, 1988. The amendments are proposed to be generally effective for plan years beginning after December 31, 1988.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (EE-167-86), 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary regulations *** amend Part 1 of the Code of Federal Regulations. New §1.410(a)-3T, §1.410(a)-8T, §1.410(a)-9T, §1.411(a)-3T, §1.411(a)-4T, and §1.411(a)-8T are added to Part 1 of Title 26 of the Code of Federal Regulations. When these temporary regulations are promulgated as final regulations, §1.410(a)-3, §1.410(a) 5, §1.410(a)-7, §1.411(a)-3, §1.411(a)-4, and §1.411(a)-8 will be revised to reflect the new provisions. For the text of the temporary regulations, see T.D. 8170, *** [page 118, this Bulletin]. The preamble to the temporary regulations explains the amendments to the Income Tax Regulations.

REGULATORY FLEXIBILITY ACT AND EXECUTIVE ORDER 12291

Although this document is a notice of proposed rulemaking which solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

COMMENTS AND REQUEST FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on January 5, 1988, 8:45 a.m., and published in the issue of the Federal Register for January 6, 1988 53 F.R. 261)

Notice of Proposed Rulemaking

Continued Accruals Beyond Normal Retirement Age

EE-184-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the requirement for continued accruals beyond normal retirement age under employee pension benefit plans. Changes to the applicable tax law were made by the Omnibus Budget Reconciliation Act of 1986. These regulations will provide the public with guidance needed to comply with the minimum participation and vesting standards and affect employers maintaining employee retirement plans.

DATES: Written comments and request for a public hearing must be delivered or mailed by June 10, 1988. These amendments generally apply to plan years beginning after December 31, 1987, except as otherwise specified in the Omnibus Budget Reconciliation Act of 1986.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (EE-184-86) Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 410 and 411 of the Internal Revenue Code of 1986. These amendments are proposed to conform the regulations to sections 9201 through 9204, Subtitle C (Older Americans Pension Benefits) of Title IX of the Omnibus Budget Reconciliation Act of 1986 (Pub. L. 99-509) (OBRA 1986) (100 Stat. 1874, 1973).

EXPLANATION OF PROVISIONS

Section 9202(b)(1) of OBRA 1986 added subparagraph (H) to section 411(b)(1) of the Internal Revenue Code (Code) to provide rules for continued benefit accruals under defined benefit plans without regard to the attainment of any age. Section 9202(b)(2) of OBRA 1986 redesignated paragraphs (2) and (3) of Code section 411(b) as paragraphs (3) and (4) and added a new paragraph (2) to Code section 411(b) to provide rules for allocations to the accounts of employees in defined contribution plans without regard to the attainment of any age.

Effective with respect to plan years beginning after December 31, 1987, section 411(b)(1)(H)(i) provides the general rule that a defined benefit plan will not be treated as meeting the minimum vesting standards of section 411 (and, accordingly, will not constitute a qualified plan under section 401(a)) if under the plan an employee's benefit accrual is ceased, or the rate of an employee's benefit accrual is reduced, because of the attainment of any age. Effective for plan years beginning after December 31, 1987, section 411(b)(2) provides that a defined contribution plan will not be treated as satisfying the minimum vesting standards of section 411 (and, accordingly, will not constitute a qualified plan under section 401(a)) if allocations to an employee's account are ceased, or the rate of allocations to an employee's account is reduced, because of the attainment of any age.

The proposed regulations provide that reductions or cessations of account allocations or benefit accruals that are based on factors other than age will not affect the qualification of the plan under section 411(b)(1)(H) or (b)(2). The proposed regulations also provide that benefits under a defined benefit plan may accrue at different rates without violating section 411(b)(1)(H), provided the difference in the rate of benefit accrual is determined without regard to the attainment of any age.

Section 411(b)(1)(H)(ii) provides that a plan will not be treated as failing to satisfy the general rule in section 411(b)(1)(H)(i) merely because the plan contains a limitation (determined without regard to age) on the maximum number of years of service or participation that are taken into account in determining benefits under the plan or merely because the plan contains a limitation on the amount of benefits an employee will receive under the plan. The proposed regulations provide that these limitations are permitted in both defined benefit plans and defined contribution plans (including target benefit plans).

Section 411(b)(1)(H)(iii) provides that, with respect to a employee who, as of the end of a plan year, has attained normal retirement age under a defined benefit plan, certain adjustments may be made to the benefit accrual for the plan year if the plan distributes benefits to the employee or if the plan adjusts the amount of the benefits payable to take into account delayed payment. The continued benefit accrual rules of section 411(b)(1)(H) operate in conjunction with the suspension of benefit payment rules under section 203(a)(3)(B) of the Employee Retirement Income Security Act of 1974 (ERISA) and the proposed regulations do not change the rules relating to the suspension of pension benefit payments under section 203(a)(3)(B) of ERISA and the regulations thereunder issued by the Department of Labor. However, the proposed regulations provide rules under which benefit accruals required under section 411(b)(1)(H)(i) may be reduced or offset either by the value of actuarial adjustments in an employee's normal retirement benefit or by the value of benefit distributions made to an employee.

Section 411(b)(1)(H)(iv) provides that a defined benefit plan will not be treated as failing to satisfy the general rule of section 411(b)(1)(H)(i) merely because the subsidized portion of an early retirement benefit provided under the plan (whether provided on a permanent or temporary basis) is disregarded in determining benefit accruals under the plan. The proposed regulations also provide that a plan will not be treated as failing to satisfy the general rule of section 411(b)(1)(H)(i) merely because a social security supplemental benefit or a qualified disability benefit is disregarded in determining benefit accruals under the plan.

The proposed regulations provide that the rate of an employee's benefit accrual under a defined benefit plan or the rate of allocations to an employee's account under a defined contribution plan will be considered to be reduced on account of the attainment of a specified age if optional forms of benefits, ancillary benefits or other benefits, rights or features under a plan that are provided with respect to benefits or allocations prior to such age are not provided (on terms that are at least as favorable to employees) with respect to benefits or allocations after such age. Thus, for example, under the proposed regulations, a plan may not make a lump sum option available only with respect to benefits or allocations attributable to service prior to a specified age. Similarly, a plan may not use actuarial assumptions that are less favorable to employees for determining lump sum benefits payable after a specified age than are used for determining lump sum benefits payable prior to such age. However, the proposed regulations provide that the accrual rate under a defined benefit plan will not be considered to be reduced merely because the subsidized portion of an early retirement benefit, a qualified disability benefit or a social security supplemental benefit provided under the plan ceases to be provided to an employee or is provided on a reduced basis to an employee by a plan on account of the employee's attainment of a specified age.

Section 411(b)(1)(H)(v) and (b)(2)(D) provide that the Secretary shall prescribe regulations coordinating the requirements of section 411(b)(1)(H) and (b)(2) with the requirements of sections 411(a), 404, 410, 415 and the anti-discrimination provisions of subchapter D of Chapter 1 (Code sections 401 through 425). The proposed regulations provide that no allocation to the account of an employee in a defined contribution plan and no benefit accrual on behalf of an employee in a defined benefit plan are required under section 411(b)(1)(H) or (b)(2) if such allocation or benefit accrual would cause the plan to (1) exceed the section 415 limitations on benefits and contributions, or (2) discriminate in favor of highly compensated employees within the meaning of section 401(a)(4).

Section 9203(a)(2) of OBRA 1986 amended Code section 410(a)(2) to provide that a plan will not constitute a qualified plan under section 401(a) if the plan excludes from participation (on the basis of age) an employee who has attained a specified age. The proposed regulations provide that, effective for plan years beginning after December 31, 1987, a plan may not apply a maximum age provision to any employee who has at least one hour of service for the employer on or after January 1, 1988, regardless of when the employee first performed an hour of service for the employer.

In the case of an employee who was ineligible to participate in a plan before the effective date of amended Code section 410(a)(2) because of a maximum age condition and who is eligible to participate in the plan on or after the effective date of such section, hours of service and years of service credited to the employee before the first plan year beginning on or after January 1, 1988, shall be taken into account in accordance with section 411 and the regulations thereunder and in accordance with 29 CFR Part 2530 for purposes of determining the employee's nonforfeitable right to the employee's accrued benefit. However, with respect to an employee described in the preceding sentence, hours of service and years of service credited to the employee before the first plan year beginning on or after January 1, 1988, are not required to be taken into account for purposes of determining the employee's accrued benefit under the plan for plan years beginning on or after January 1, 1988. See, also, section 411(a)(4) and §1.411(a)-5 for rules relating to service that must be taken into account in determining an employee's nonforfeitable right to the employee's accrued benefit.

Section 9203(b)(2) of OBRA 1986 amended Code section 411(a)(8)(B) to provide rules relating to the determination of a participant's normal retirement age under a defined benefit plan and a defined contribution plan. Because section 203(e) of the pending Technical Corrections Act of 1987 (H.R. 2636) would change the definition of normal retirement age from the definition now set forth in section 411(a)(8)(B) (as amended by OBRA 1986), the proposed regulations do not set forth any rules under section 411(a)(8)(B) (as amended by OBRA 1986).

Section 9202(b) of OBRA 1986 amended Code section 411(b)(2)(C) to require the Secretary to provide by regulations for the application of the continued allocation rules of section 411(b)(2) to target benefit plans. The proposed regulations do not provide detailed special rules applicable to target benefit plans. Target benefit plans are subject to the rules applicable to defined contribution plans. The Commissioner will prescribe such additional rules relating to the continued allocation of contributions and accrual of benefits under target benefit plans as may be necessary or appropriate.

EFFECTIVE DATE

Section 9204(a)(1) of OBRA 1986 provides that the amendments made with regard to section 411(b)(1)(H) and (b)(2) "shall apply only with respect to plan years beginning on or after January 1, 1988, and only to employees who have 1 hour of service in any plan year to which such amendments apply." The proposed regulations provide that section 411(b)(1)(H) and (b)(2) does not apply to an employee who does not have at least 1 hour of service for the employer in a plan year beginning on or after January 1, 1988.

However, the proposed regulations provide that section 411(b)(1)(H) and (b)(2) applies with respect to all years of service completed by an employee who has at least 1 hour of service in a plan year beginning on or after January 1, 1988. Accordingly, under section 411(b)(1)(H)(i), the proposed regulations provide that, for plan years beginning on or after January 1, 1988, in determining the benefit payable under a defined benefit plan to a participant who has at least 1 hour of service in a plan year beginning on or after January 1, 1988, the plan does not satisfy section 411(a) if the plan disregards, because of the participant's attainment of any age, any year of service completed by the participant or any compensation earned by the participant after attaining such age, including years of service completed and compensation earned before the first plan year beginning on or after January 1, 1988. Under the proposed regulations, section 411(b)(2) does not require allocations to the accounts of employees under a defined contribution plan for any plan year beginning before January 1, 1988. However, the proposed regulations provide that, for plan years beginning on or after January 1, 1988, in determining the allocation to the account of a participant (who has at least 1 hour of service in a plan year beginning on or after January 1, 1988) under a defined contribution plan that determines allocations under a service related allocation formula, the plan does not satisfy section 411(a) if the plan disregards, because of the participant's attainment of any age, any year of service completed by the participant.

Under the proposed regulations, a defined benefit plan and a defined contribution plan will not be treated as impermissibly disregarding, because of the participant's attainment of any age, a year of service completed by the participant before the first plan year beginning before January 1, 1988, merely because the participant was not eligible under the plan to make mandatory or voluntary employee contributions (as well as contributions under a cash or deferred arrangment described in section 401(k)) for such year.

TITLE I OF ERISA AND OBRA 1986

Under section 101 of Reorganization Plan No. 4 of 1978 (43 FR 47713), the Secretary of the Treasury has jurisdiction over the subject matter addressed in the OBRA 1986 regulations. Therefore, under section 104 of the Reorganization Plan, these regulations apply when the Secretary of Labor exercises authority under Title I of ERISA (as amended, including the amendments made by Title IX of OBRA 1986 and the amendments by the Tax Reform Act of 1986). Thus, the requirements also apply to employee plans subject to Part 2 of Title I of ERISA.

Under section 9201 of OBRA 1986, these regulations also apply for purposes of applying comparable provisions under section 4(i)(7) of the Age Discrimination in Employment Act of 1967 (29 U.S.C. 623) as amended. No inference is intended under the proposed regulations as to the application of the Age Discrimination in Employment Act of 1967, as in effect prior to its amendment by OBRA 1986, to employees who are not credited with at least 1 hour of service in a plan year beginning on or after January 1, 1988.

RELIANCE ON THESE PROPOSED REGULATIONS

Taxpayers may rely on these proposed regulations for guidance pending the issuance of final regulations. Because these regulations are generally effective for plan years beginning after 1987, the Service will apply these proposed regulations in issuing rulings and in examining returns with respect to taxpayers and plans. If future guidance is more restrictive, such guidance will be applied without retroactive effect.

TIME OF PLAN AMENDMENTS

The proposed regulations provide rules relating to the postponement of the deadline for amending plans to comply with the provisions of OBRA 1986. Plan amendments required to conform the plan to the changes contained in OBRA 1986 need not be made until the dates specified in section 1140 of the Tax Reform Act of 1986 (in general, the last day of the first plan year commencing on or after January 1, 1989). This deferred amendment date is available only if: (1) the plan is operated in accordance with the applicable provisions of OBRA 1986 for the period beginning with the effective date of the provision with respect to the plan; (2) the plan amendments adopted are retroactive to such effective date; and (3) the plan amendments adopted are consistent with plan operation during the retroactive effective period.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis is not required.

Although this document is a notice of proposed rulemaking which solicits public comments, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

* * * * *

Proposed amendments to the regulations

The proposed amendments to 26 CFR Part 1 are as follows:

INCOME TAX REGULATIONS

(26 CFR Part 1)

Paragraph 1. The authority citation for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805 *** Section 1.411(b)-2 is also issued under 26 U.S.C. 411(b)(1)(H) and 411(b)(2).

Par. 2. A new §1.410(a)-4A is added immediately after §1.410(a)-4 to read as follows:

§1.410(a)-4A Maximum age conditions after 1987.

(a) *Maximum age conditions*. Under section 410(a)(2), a plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if the plan, either directly or indirectly, excludes any employee from participation on the basis of attaining a maximum age.

(b) *Effective date and transitional rule*. If a plan contains a provision that excludes an employee from participation on the basis of attaining a maximum age, the provision may not be applied in a plan year beginning on or after January 1, 1988, to any employee (regardless of when the employee first performed an hour of service for the employer) who is credited with at least 1 hour of service on or after January 1, 1988. For purposes of determining when such an employee (who is not otherwise ineligible to participate in the plan) must become eligible to participate in the plan under section 410(a)(1)(A)(ii), section 410(a)(1)(B) and the provisions of the plan, hours of service and years of service credited to the employee before the first plan year beginning on or after January 1, 1988, are taken into account in accordance with section 410 and the regulations thereunder and in accordance with 29 CFR Part 2530. Any employee who would be eligible to participate in the plan taking such service into account and whose entry date would be prior to the first day of the first plan year beginning on or after January 1, 1988, must participate in the plan as of the first day of such plan year.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). Employer X maintains a defined benefit plan that uses a 12-month period beginning July 1 and ending June 30 as its plan year and that specifies a normal retirement age of 65. The plan provides that each employee of X is eligible to become a participant in the plan on the first entry date on or after the employee completes 1 year of service for X. The plan has 2 entry dates, July 1 and January 1. However, prior to the plan year beginning July 1, 1988, the plan contained a provision that excluded from participation any employee first hired within 5 years of attaining the plan's specified normal retirement age of 65. Employee A was hired by X on August 1, 1986 at age 62. A completes 1 year of service for X by August 1, 1987. If A performs at least one hour of service for X on or after January 1, 1988, the plan, in order to meet the requirements of section 410(a)(2), may not apply the maximum age provision to A on or after July 1, 1988, and A must be eligible to become a participant in the plan in accordance with the other eligibility rules contained in the plan, taking into account A's service with X performed prior to July 1, 1988 to the extent required under the terms of the plan or under section 410 and the regulations thereunder and under regulations in 29 CFR Part 2530. Accordingly, if A is still employed by X on July 1, 1988, A must become a participant in the plan on that date.

Example (2). Employer X maintains a defined benefit plan that uses the calendar year as its plan year and that specifies a normal retirement age of 65. Employee B is first hired by Y in 1988 when B is age 60. In order for the plan to meet the requirements of section 410(a)(2), B may not be excluded from plan participation on the basis of B having attained a specified age.

Par. 3. Section 1.411(a)-1 is amended by revising paragraph (a)(3) to read as follows:

§1.411(a)-1 Minimum vesting standards; general rules.

(a) *In general.* ***

(3) The plan satisfies the requirements of—

(A) Section 411(a)(2) and §1.411(a)-3 (relating to vesting in accrued benefit derived from employer contributions),

(B) In the case of a defined benefit plan, section 411(b)(1) and (3) (see §§1.411(b)-1 and 1.411(b)-2, relating to accrued benefit requirements, separate accounting and accruals and allocations after a specified age), and

(C) In the case of a defined contribution plan, section 411(b)(2) and (3) (see §§1.411(b)-1(e)(2) and 1.411(b)-2, relating to accruals and allocations after a specified age and separate accounting).

* * * * *

Par. 4. Section 1.411(a)-7 is amended by adding a new subparagragh (b)(3) to read as follows:

§1.411(a)-7 Definitions and special rules.

* * * * *

(b) *Normal retirement age.****

(3) *Effect of Omnibus Budget Reconciliation Act of 1986 (OBRA).* [RESERVED]

* * * * *

Par. 5. A new section 1.411(b)-2 is added after §1.411(b)-1 to read as follows:

§1.411(b)-2 Accruals and allocations after a specified age.

(a) *In general.* Section 411(b)(1)(H) provides that a defined benefit plan does not satisfy the minimum vesting standards of section 411(a) if, under the plan, benefit accruals on behalf of a participant are discontinued or the rate of benefit accrual on behalf of a participant is reduced because of the participant's attainment of any age. Section 411(b)(2) provides that a defined contribution plan does not satisfy the minimum vesting standards of section 411(a) if, under the plan, allocations to a participant's account are reduced or discontinued or the rate of allocations to a participant's account is reduced because of the participant's attainment of any age. A defined benefit plan is not considered to discontinue benefit accruals or reduce the rate of benefit accrual on behalf of a participant because of the attainment of any age in violation of section 411(b)(1)(H) and a defined contribution plan is not considered to reduce or discontinue allocations to a particpant's account or reduce the rate of allocations to a participant's account because of the attainment of any age in violation of section 411(b)(2) solely because of a positive correlation between increased age and a reduction or discontinuance in benefit accruals or account allocations under a plan. Thus, for example, if a defined benefit plan or a defined contribution plan provides for reduced or discontinued benefit accruals or account allocations on behalf of participants who have completed a specified number of years of credited service, the plan will not thereby fail to satisfy section 411(b)(1)(H) or (b)(2) solely because of a positive correlation between increased age and completion of the specified number of years of credited service. See paragraph (b)(2) of this section for rules relating to benefit and service limitations under defined benefit plans and paragraph (c)(2) of this section for rules relating to limitations on allocations under defined contribution plans. Also, if benefit accruals or the rate of benefit accrual on behalf of a participant in a defined benefit plan or allocations or the rate of allocations to the account of a particpant in a defined contribution plan are reduced or discontinued under the plan and the reason for the reduction or discontinuance is neither directly nor indirectly related to the participant's attainment of a specified age, the plan does not thereby fail to satisfy the requirements of section 411(b)(1)(H) or (b)(2). Thus, for example, if a defined benefit plan is amended to cease or reduce the rate of benefit accrual for all plan participants, such cessation or reduction does not fail to saisfy the requirements of section 411(b)(1)(H).

(b) *Defined benefit plans*—(1) *In general.* (i) A defined benefit plan does not satisfy the minimum vesting standards of section 411(a) if, either directly or indirectly, because of the attainment of any age—

(A) A participant's accrual of benefits is discontinued or the rate of a participant's accrual of benefits is decreased, or

(B) A participant's compensation after the attainment of such age is not taken into account in determining the participant's accrual of benefits.

(ii) In determining whether a defined benefit plan satisfies paragraph (b)(1)(i) of this section, the subsidized portion of an early retirement benefit (whether provided on a temporary or permanent basis), a social security supplement (as defined in §1.411(a)-7(c)(4)(ii)) and a qualified disability benefit (as defined in §1.411(a)-7(c)(3)) are disregarded in determining the rate of a participant's accrual of benefits under the plan.

(iii) The provisions of paragraph (b)(1)(i) of this section may be illustrated by the following example. In the example, assume that the participant completes the hours of service in a plan year required under the plan to accrue a full benefit for the plan year.

Example. Employer X maintains a defined benefit plan that provides a normal retirement benefit of 1% of a participant's average annual compensation, multiplied by the participant's years of credited service under the plan. Normal retirement age under the plan is age 65. The plan contains no limitations (other than the limitations imposed by section 415) on the maximum amount of benefits the plan will pay to any participant or on the maximum number of years of credited service taken into account under the plan for purposes of determining the amount of any participant's normal retirement benefit. Participant A became a participant in the plan at age 25 and worked continuously for X until A retires at age 70. The plan will satisfy the requirements of section 411(b)(1)(H) and paragraph (b)(2) of this section if, under the plan's benefit formula, upon A's retirement, A has an accrued normal retirement benefit of at least 45% of A's average annual compensation (1% per year × 45 years).

(2) *Benefit and service limitations*—(i) *In general*. A defined benefit plan does not fail to satisfy section 411(b)(1)(H) and paragraph (b) of this section solely because the plan limits the amount of benefits a participant may accrue under the plan or limits the number of years of service or years of participation taken into account for purposes of determining the accrual of benefits under the plan (credited service). For this purpose, a limitation that is expressed as a percentage of compensation (whether averaged over a participant's total years of credited service for the employer or over a shorter period) and a limitation of the type described in section 401(a)(5)(D) are treated as permissible limitations on the amount of benefits a participant may accrue under the plan. However, in applying a limitation on the number of years of credited service that are taken into account under a plan, the plan may not take into account any year of service that is disregarded in determining the accrual of benefits under the plan (prior to the effective date of section 411(b)(1)(H) and this section) because of the attainment of any age.

(ii) *Limitation not based on age.* Any limitation on the amount of benefits a participant may accrue under the plan and any limitation on the number of years of credited service taken into account under the plan may not be based, directly or indirectly, on the attainment of any age. A limitation that is determined by reference to age or that is not determinable except by reference to age is considered a limitation directly based on age. Thus, a plan provision that, for purposes of benefit accrual, disregards years of service completed after a participant becomes eligible to receive social security benefits is considered a limitation directly based on age. Similarly, a plan provision that, for purposes of benefit accrual, disregards years of service completed after the sum of a participant's age and the participant's number of years of credited service equals a specified number, is considered a limitation directly based on age. Whether a limitation is indirectly based on age is determined with reference to all the facts and circumstances.

(iii) *Examples.* The provisions of paragraph (b)(2) of this section may be illustrated by the following examples. In each example, assume that the participant completes the hours of service in a plan year required under the plan to accrue a full benefit for the plan year.

Example (1). Assume the same facts as in the *Example* set forth in paragraph (b)(1)(ii) of this section, except that the plan provides that not more than 35 years of credited service will be taken into account in determining a participant's normal retirement benefit under the plan. Upon A's retirement at age 70, A will have a normal retirement benefit under the plan's benefit formula of 35% of A's average annual compensation (1% per year × 35 years). The plan will not fail to satisfy the requirements of section 411(b)(1)(H) and this paragraph (b) merely because the plan provides that the final 10 years of A's service under the plan is not taken into account in determining A's normal retirement benefit. The result would be the same if the plan provided that no participant could accrue a normal retirement benefit in excess of 35% of the participant's average annual compensation.

Example (2). Employer Y maintains a defined benefit plan that provides a normal retirement benefit of 50% of a participant's final average compensation. Normal retirement age under the plan is age 65. Other than the limitations imposed by section 415, the plan contains no provision that limits the accrual of the benefit payable to a participant who has less than a specified number of years of credited service for Y. Participant A is hired by Y at age 66 and commences participation in the plan at age 67. Under the plan's benefit formula, if A completes one year of credited service under the plan, A will be entitled to receive (subject to the limitations of section 415) a normal retirement benefit equal to 50% of A's final average compensation.

(3) *Different rates of benefit accrual*—(i) *In general.* A defined benefit plan does not fail to satisfy the requirements of section 411(b)(1)(H) and paragraph (b) of this section solely because the plan provides for the accrual of benefits at different rates with respect to participants under the plan. Accordingly, a plan under which a participant's accrued benefit is determined in accordance with the fractional rule described in section 411(b)(1)(C) and §1.411(b)-1 (b)(3) will not fail to satisfy the requirements of section 411(b)(1)(H) and paragraph (b) of this section solely because the rate at which a participant's normal retirement benefit accrues differs depending on the number of years of credited service a participant would have between the date of commencement of participation and the attainment of normal retirement age. In addition, a plan will not be treated as failing to satisfy section 411(b)(1)(H) and paragraph (b) of this section solely because the plan's benefit formula provides, on a uniform and consistent basis, a normal retirement benefit equal to, for example, 2% of average annual compensation multiplied by a participant's first 15 years of credited service and 1% of average annual compensation multiplied by a participant's years of credited service in excess of 15 years. The preceding sentence applies regardless of when the participant's normal retirement age occurs.

(ii) *Differences not based on age.* Any differences in the rate of benefit accrual described in paragraph (b)(3)(i) of this section may not be based, directly or indirectly, on the attainment of any age.

(4) *Certain adjustments for delayed retirement*—(i) *In general.* Under section 411(b)(1)(H)(iii), a plan may provide that benefit accruals that would otherwise be required under section 411(b)(1)(H)(i) and paragraph (b) of this section for a plan year are reduced (but not below zero) as set forth in paragraph (b)(4)(ii) and (iii) of this section. This paragraph (b)(4) applies for a plan year to a participant who, as of the end of the plan year, has attained normal retirement age under the plan.

(ii) *Distribution of benefits.* (A) A plan may provide that the benefit accrual otherwise required under section 411(b)(1)(H)(i) and paragraph (b) of this section for a plan year is reduced (but not below zero) by the actuarial equivalent of total plan benefit distributions (as determined under this paragraph (b)(4)(ii)) made to the participant by the close of the plan year.

(B) The plan benefit distributions described in this paragraph (b)(4)(ii) are limited to distributions made to the participant during plan years and periods with respect to which section 411(b)(1)(H)(i) and this section apply (including plan years and periods beginning before January 1, 1988) for which the plan could (without regard to section 401(a)(9) and the regulations thereunder) provide for the suspension of the participant's plan benefits in accordance with section 203(a)(3)(B) of the Employee Retirement Income Security Act of 1974 (ERISA) and regulations issued thereunder by the Department of Labor.

(C) For purposes of determining the total amount of plan benefit distributions that may be taken into account under this paragraph (b)(4)(ii) as of the close of a plan year, distributions shall be disregarded to the extent the total amount of distributions made to the participant by the close of the plan year exceeds the total amount of the distributions the participant would have received by the close of the plan year if the distributions had been made in accordance with the plan's normal form of benefit distribution. Accordingly, the plan is required to accrue a benefit for the plan year on behalf of a participant in accordance with the plan's benefit formula, taking into account all of the participant's years of credited service, reduced (but not below the participant's normal retirement benefit for the prior plan year) by the actuarial equivalent of total benefit distibutions (taken into account under this paragraph (b)(4)(ii)) made to the participant by the close of the plan year. If, by the close of the plan year, the actuarial equivalent of total plan benefit distributions made to the participant and taken into account under this paragraph (b)(4)(ii) is greater than the total benefit accruals required under section 411(b)(1)(H)(i) and paragraph (b) of this section for the plan years during which such distributions were made, the plan is not required under section 411(b)(1)(H)(i) and paragraph (b) of this section to accrue any benefit on behalf of the participant for the plan year.

(iii) *Adjustment in benefits payable.* (A) A plan may provide that the benefit accrual otherwise required under section 411(b)(1)(H)(i) and paragraph (b) of this section for the plan year is reduced (but not below zero) by the amount of any actuarial adjustment under the plan in the benefit payable for the plan year with respect to the participant because of a delay in the payment of plan benefits after the participant's attainment of normal retirement age.

(B) For purposes of subdivision (iii)(A), the actuarial adjustment may be taken into account for a plan year only to the extent it is made to the greater of *(1)* the participant's retirement benefit as of the close of the prior plan year, including any actuarial adjustment made under the plan for the prior plan year, and *(2)* the participant's normal retirement benefit as of the close of the prior plan year determined by including benefit accruals required by section 411(b)(1)(H)(i) and paragraph (b) of this section. If the retirement benefit, as actuarially adjusted for the plan year in accordance with this paragraph (b)(4)(iii) for delayed payment, exceeds the normal retirement benefit, as determined by including benefit accruals required for the plan year by section 411(b)(1)(H)(i) and paragraph (b) of this section, the plan shall be required to provide the retirement benefit, as actuarially adjusted in acordance with this paragraph (b)(4)(iii) under the plan. Notwithstanding the provisions of this subdivision (iii)(B), in the case of a plan that suspends benefit payments in accordance with section 203(a)(3)(B) of the Employee Retirement Income Security Act of 1974 and the regulations issued thereunder by the Department of Labor, the plan does not fail to satisfy the requirements of section 411(b)(1)(H) and paragraph (b) of this section solely because the plan provides that the retirement benefit to which a participant is entitled as of the close of a plan year ending after the participant attains normal retirement age under the plan is the greater of *(1)* the benefit payable at normal retirement age (not including benefit accruals otherwise required by section 411(b)(1)(H) and paragraph (b) of this section) actuarially adjusted under the plan to the close of the plan year for delayed payment, and *(2)* the retirement benefit determined under the plan as of the close of the plan year determined by including benefit accruals required by section 411(b)(1)(H) and paragraph (b) of this section and determined without regard to any offset that would otherwise be applicable under this paragraph (b)(4)(iii).

(iv) *Examples.* The provisions of paragraph (b)(4) of this section may be illustrated by the following examples. In each example, assume that the participant completes the hours of service in a plan year required under the plan to accrue a full benefit for the plan year and assume that the participant is not married unless otherwise specified.

Example (1). Employer Y maintains a defined benefit plan that provides a normal retirement benefit of $20 per month multiplied by the participant's years of credited service. The plan contains no limit on the number of years of credited service taken into account for purposes of determining the normal retirement benefit provided by the plan. Participant A attains normal retirement age of 65 and continues in the full time service of Y. At age 65, A has 30 years of credited service under the plan and could receive a normal retirement benefit of $600 per month ($20 × 30 years) if A retires. The plan provides for the suspension of A's normal retirement benefit (in accordance with section 203(a)(3)(B) of the Employee Retirement Income Security Act of 1974 (ERISA) and regulations thereunder issued by the Department of Labor) during the period of A's continued employment with Y. Accordingly, the plan does not provide for an actuarial adjustment of A's normal retirement benefit because of delayed payment and the plan does not pay A's normal retirement benefit while A remains in the full time service of Y. If A retires at age 67, after completing two additional years of credited service for Y, A must receive additional accruals for the two years of credited service completed after attaining normal retirement age in order for the plan to satisfy section 411(b)(1)(H)(i). Accordingly, A is entitled to receive a normal retirement benefit of $640 per month ($20 × 32 years).

Example (2). Assume the same facts as in *Example (1)*, except that the plan provides that at the time A's normal retirement benefit becomes payable, the amount of A's normal retirement benefit (determined as of A's normal retirement age and each year thereafter) will be actuarially increased for delayed retirement. The plan offsets this actuarial increase against benefit accruals in plan years ending after A's attainment of normal retirement age, as permitted by paragraph (b)(4)(iii) of this section. Accordingly, the plan does not provide for the suspension of normal retirement benefits (in accordance with section 203(a)(3)(B) of ERISA and regulations thereunder issued by the Department of Labor). Under section 411(b)(1)(H), the plan must provide A with a benefit of at least $620 per month after A completes 31 years of credited service for Y. However, under paragraph (b)(4)(iii) of this section, the plan is not required to provide A with a benefit accrual for A's additional year of credited service for Y because, under the plan, A will be entitled to receive, upon retirement at age 66 after completing 1 additional year of credited service for Y, an actuarially increased benefit of $672 per month. This monthly benefit of $672 is the greater of A's normal retirement benefit at normal retirement age ($20 × 30 years = $600) actuarially adjusted for delayed payment and A's normal retirement benefit ($20 × 31 years = $620) determined by taking into account A's year of credited service after attaining normal retirement age. Under the plan, A will be entitled to receive, upon retirement at age 67 after completing 2 additional years of credited service for Y after attaining normal retirement age, an actuarially increased benefit of $756 per month. This monthly benefit of $756 is the greater of A's actuarially adjusted normal retirement benefit at age 66 ($672) actuarially adjusted to $756 for delayed payment to age 67 and A's normal retirement benefit ($20 × 32 years = $640) determined by taking into account A's years of credited service after attaining normal retirement age.

Example (3). Assume the same facts as in *Example (1)*, except that the plan neither provides for the suspension of normal retirement benefit payments (in accordance with section 203(a)(3)(B) of ERISA and regulations thereunder issued by the Department of Labor) nor provides for an actuarial increase in benefit payments because of delayed payment of benefits. Consequently, the plan provides that the normal retirement benefit will be paid to a participant, beginning at age 65 (normal retirement age) even though the participant remains in the service of Y and offsets the value of the benefit distributions against benefit accruals in plan years ending after the participant's attainment of normal retirement age, as permitted by paragraph (b)(4)(ii) of this section. Participant B (who remains in the full time service of Y) receives 12 monthly benefit payments prior to attainment of age 66. The total monthly benefit payments of $7,200 ($600 × 12 payments) have an actuarial value at age 66 of $7,559 (reflecting interest and mortality) which would produce a monthly benefit of $72 commencing at age 66. The benefit accrual for the year of credited service B completed after attaining normal retirement age is $20 per month ($20 × 1 year). Because the actuarial value (determined as a monthly benefit of $72) of the benefit payments made during the one year of credited service after B's attainment of normal retirement age exceeds the benefit accrual for the one year of credited service after B's attainment of normal retirement age, the plan is not required to accrue benefits on behalf of B for the one year of credited service after B's attainment of normal retirement age and the plan is not required to increase B's monthly benefit payment of $600 at age 66. Assume B receives 24 monthly benefit payments prior to B's retirement at age 67. The total monthly benefit payments of $14,400 ($600 × 24 payments) have an actuarial value at age 67 of $15,839 (reflecting interest and mortality) which would produce a monthly benefit payment of $156 commencing at age 67. The benefit accrual for the two years of credited service B completed after attaining normal retirement age is $40 per month ($20 × 2 years). Because the actuarial value (determined as a monthly benefit of $156) of the benefit payments made during the two years of credited service after B's normal retirement age exceeds the benefit accrual for the two years of credited service after B's normal retirement age ($20 × 2 years = $40), the plan is not required to accrue benefits on behalf of B for the second year of credited service B completed after attaining normal retirement age and the plan is not required to increase B's monthly benefit payment of $600.

Example (4). Assume that Employer Z maintains a defined benefit plan that provides a normal retirement benefit of 2% of the average of a participant's high three consecutive years of compensation multiplied by the participant's years of credited service under the plan. The plan contains no limit on the number of years of credited service taken into account for purposes of determining the normal retirement benefit provided by the plan. Participant C, who has attained normal retirement age (age 65) under the plan, continues in the full time service of Z. At normal retirement age, C has average compensation of $20,000 for C's high three consecutive years and has 10 years of credited service under the plan. Thus, at normal retirement age, C is entitled to receive an annual normal retirement benefit of $4,000 ($20,000 × .01 × 10 years). Assume further that the plan provides for the suspension of N's normal retirement benefit (in accordance with section 203(a)(3)(B) of ERISA and regulations issued thereunder by the Department of Labor) during the period of C's continued employment with Z. Accordingly, the plan does not provide for the actuarial increase of C's normal retirement benefit because of delayed payment and the plan does not pay C's normal retirement benefit while C remains in the full time service of Z. At age 70, when C retires, C has average annual compensation for C's high three consecutive years of $35,000. Under section 411(b)(1)(H), C must be credited with 15 years of credited service for Z and C's increased compensation after attaining normal retirement age must be taken into account for purposes of determining C's normal retirement benefit. At age 70, C is entitled to receive an annual normal retirement benefit of $10,500 ($35,000 × .02 × 15 years).

Example (5). Assume the same facts as in *Example (4)*, except that the payment of C's retirement benefit is not suspended (in accordance with section 203(a)(3)(B) of ERISA and regulations issued thereunder by the Department of Labor) and, accordingly, the plan provides that retirement benefits that commence after a participant's normal retirement age will be actuarially increased for late retirement. The plan offsets this actuarial increase against benefit accruals in plan years ending after C's attainment of normal retirement age, as permitted by paragraph (b)(4)(iii) of this section. Under this provision, at the close of each plan year after C's attainment of normal retirement age, C's retirement benefit is actuarially increased. Under this provision, the actuarial increase for the plan year is made to the greater of C's normal retirement benefit at the close of the prior plan year (including previous actuarial adjustments) and C's normal retirement benefit at the close of the prior plan year determined by including all benefit accruals. Accordingly, at the close of each plan year, C is entitled to receive an annual normal retirement benefit equal to the greater of C's normal retirement benefit (adjusted actuarially under the plan from the benefit to which C was entitled at the close of the prior plan year) determined at the close of the plan year and C's normal retirement benefit determined at the close of the plan year by taking into account C's years of credited service and benefit accruals after C's attainment of normal retirement age. The foregoing is illustrated in the following table with respect to certain years of credited service performed by C after attaining normal retirement age 65.

1 Age	2 Years of credited service	3 Average compensation for high three consecutive years	4 Normal retirement benefit with additional accruals (.02 × Column 2 × Column 3)	5 Retirement benefit, as actuarially increased under the plan from the benefit at prior age (Column 6)	6 Normal retirement benefit to which C is entitled (greater of Column 4 and Column 5)
65	10	$20,000	$4,000	N/A	$4,000
66	11	$21,000	$4,620	$4,482	$4,620
67	12	$29,000	$6,960	$5,192	$6,960
68	13	$30,000	$7,800	$7,848	$7,848
69	14	$33,000	$9,240	$8,880	$9,240
70	15	$35,000	$10,500	$10,494	$10,500

Example (6). Assume the same facts as in *Example (4)*, except that C does not retire at age 70, but continues in the full time service of Z. Upon C's attainment of age 70, the plan commences benefit payments to C. The annual benefit paid to C in the first plan year is $10,500 ($35,000 × .02 × 15 years). In determining the annual benefit payable to C in each subsequent plan year, the plan offsets the value of benefit distributions made to the participant by the close of the prior plan year against benefit accruals in plan years during which such distributions were made, as permitted by paragraph (b)(4)(ii) of this section. Accordingly, for each subsequent plan year, C is entitled under the plan to receive benefit payments based on C's benefit (at the close of the prior plan year) determined under the plan formula by taking into account all of C's years of credited service, reduced (but not below C's normal retirement benefit for the prior plan year) by the value of total benefit distributions made to C by the close of the prior plan year. The foregoing is illustrated in the following table with respect to certain years of credited service performed by C while benefits were being distributed to C.

1 Years of benefit distributions	2 Years of credited service (as of close of the year)	3 Average compensation for high three years	4 Normal retirement benefit with additional accruals (.02 × Column 2 × Column 3)	5 Suspendible benefit distributions made during the year	6 Cumulative suspendible benefit distributions made as of close of the year	7 Annual benefit that is actuerial equivalent of cumulative suspendible benefit distributions made as of close of the year	8 Retirement benefit to which C is entitled at close of the year (Column 4 – Column 7, but not less than Column 8 for prior year)
N/A	15	$35,000	$10,500	N/A	N/A	N/A	$10,500
1	16	$35,000	$11,200	$10,500	$10,500	$1,472	$10,500
2	17	$45,000	$15,300	$10,500	$21,000	$3,209	$12,091
3	18	$50,000	$18,000	$12,091	$33,091	$5,510	$12,490

(c) *Defined contribution plans*—(1) *In general*. A defined contribution plan (including a target benefit plan described in §1.410(a)–4(a)(1)) does not satisfy the minimum vesting standards of section 411(a) if, either directly or indirectly, because of the attainment of any age—

(i) The allocation of employer contributions or forfeitures to the accounts of participants is discontinued, or

(ii) The rate at which the allocation of employer contributions or forfeitures is made to the accounts of participants is decreased.

(2) *Limitations on allocations*.

(i) A defined contribution plan (including a target benefit plan described in §1.410(a)–4(a)(1)) does not fail to satisfy the minimum vesting standards of section 411(a) solely because the plan limits the total amount of employer contributions and forfeitures that may be allocated to a participant's account (for a particular plan year or for the participant's total years of credited service under the plan) or solely because the plan limits the total number of years of credited service for which a participant's account may receive allocations of employer contributions and forfeitures. The limitations described in the preceding sentence may not be applied with respect to the allocation of gains, losses or income of the trust to the account of a participant. Furthermore, a defined contribution plan (including a target benefit plan) does not fail to satisfy section 411(a) solely because the plan limits the number of years of credited service that may be taken into account for purposes of determining the amount of, or the rate at which, employer contributions and forfeitures are allocated to a participant's account for a particular plan year. However, in applying a credited service limitation described in this paragraph (c)(2)(i), the plan may not take into account any year of service (prior to the effective date of section 411(b)(2) and paragraph (c) of this section) that is disregarded in determining allocations to a participant's account because of the participant's attainment of any age.

(ii) Any limitation described in paragraph (c)(2)(i) of this section may not be based, directly or indirectly, on the attainment of any age. The provisions of paragraph (b)(2)(ii) of this section shall also apply for purposes of this paragraph (c).

(iii) The Commissioner shall provide such additional rules as may be necessary or appropriate with respect to the application of section 411(b)(2) and this section to target benefit plans.

(d) *Benefits and forms of benefits subject to requirements*—(1) *General rule*. Except as provided in paragraph (d)(2) of this section, section 411(b)(1)(H) and (b)(2) and paragraphs (b) and (c) of this section apply to all benefits (and forms of benefits) provided under a defined benefit plan and a defined contribution plan, including accrued benefits, benefits described in section 411(d)(6), ancillary benefits and other rights and features provided under the plan. Accordingly, except as provided in paragraph (d)(2) of this section, benefit accruals under a defined benefit plan and allocations under a defined contribution plan will be considered to be reduced on account of the attainment of a specified age if optional forms of benefits, ancillary benefits, or other rights or features under the plan provided with respect to benefits or allocations attributable to credited service prior to the attainment of such age are not provided (on at least as favorable a basis to participants) with respect to benefits or allocations attributable to credited service after such age. Thus, for example, a plan may not provide a lump sum payment only with respect to benefits attributable to years of credited service before the attainment of a specified age. Similarly, except as provided in paragraph (d)(2) of this section, if an optional form of benefit is available under the plan at a specified age, the availability of such form of benefit, or the method for determining the manner in which such benefit is paid, may not, directly or indirectly, be denied or provided on terms less favorable to participants because of the attainment of any higher age. Similarly, if the method for determining the amount or the rate of the subsidized portion of a joint and survivor annuity or the subsidized portion of a preretirement survivor annuity is less favorable with respect to participants who have attained a specified age than with respect to participants who have not attained such age, benefit accruals or account allocations under the plan will be considered to be reduced on account of the attainment of such age.

(2) *Special rule for certain benefits*. A plan will not fail to satisfy section 411(b)(1)(H) or paragraph (b) of this section merely because the following benefits, or the manner in which such benefits are provided under the plan, vary because of the attainment of any higher age.

(i) The subsidized portion of an early retirement benefit (whether provided on a temporary or permanent basis),

(ii) A qualified disability benefit (as defined in §1.411(a)–7(c)(3)); and

(iii) A social security supplement (as defined in §1.411(a)–7(c)(4)(ii)).

(e) *Coordination with certain provisions*. Notwithstanding section 411(b)(1)(H), (b)(2) and the preceding paragraphs of this section, the following rules shall apply.

(1) *Section 415 limitations.* No allocation to the account of a participant in a defined contribution plan (including a target benefit plan described in §1.410(a)-4(a)(1)) shall be required for a limitation year by section 411(b)(2) and no benefit accrual with respect to a participant in a defined benefit plan shall be required for a limitation year by section 411(b)(1)(H)(i) to the extent that the allocation or accrual would cause the plan to exceed the limitations of section 415 (b), (c) or (e) applicable to the participant for the limitation year.

(2) *Prohibited discrimination.* (i) No allocation to the account of a highly compensated employee in a defined contribution plan (including a target benefit plan) shall be required for a plan year by section 411(b)(2) to the extent the allocation would cause the plan to discriminate in favor of highly compensated employees within the meaning of section 401(a)(4).

(ii) No benefit accrual on behalf of a highly compensated employee in a defined benefit plan shall be required for a plan year by section 411(b)(1)(H)(i) to the extent such benefit accrual would cause the plan to discriminate in favor of highly compensated employees within the meaning of section 401(a)(4).

(iii) The Commissioner may provide additional rules relating to prohibited discrimination in favor of highly compensated employees.

(3) *Permitted disparity.* In the case of a plan that would fail to satisfy section 401(a)(4) except for the application of section 401(l), no allocation to the account of a participant in a defined contribution plan and no benefit accrual on behalf of a participant in a defined benefit plan shall be required under section 411(b)(1)(H) or (b)(2) for a plan year to the extent such allocation or accrual would cause the plan to fail to satisfy the requirements of section 401(l) and the regulations thereunder for the plan year.

(f) *Effective dates—*(1) *Noncollectively bargained plans—*(i) *In general.* Except as otherwise provided in paragraph (f)(2) of this section, section 411(b)(1)(H) and (b)(2) and paragraphs (b) and (c) of this section are effective for plan years beginning on or after January 1, 1988, with respect to a participant who is credited with at least 1 hour of service in a plan year beginning on or after January 1, 1988. Section 411(b)(1)(H) and (b)(2) and paragraphs (b) and (c) of this section are not effective with respect to a participant who is not credited with at least 1 hour of service in a plan year beginning on or after January 1, 1988.

(ii) *Defined benefit plans.* In the case of a participant who is credited with at least 1 hour of service in a plan year beginning on or after January 1, 1988, section 411(b)(1)(H) and paragraph (b) of this section are effective with respect to all years of service completed by the participant, including years of service completed before the first plan year beginning on or after January 1, 1988. Accordingly, in the case of a participant described in the preceding sentence, a defined benefit plan does not satisfy section 411(b)(1)(H) and paragraph (b) of this section for a plan year beginning on or after January 1, 1988, if the plan disregards, because of the participant's attainment of any age, any year of service completed by the participant or any compensation earned by the participant after attaining such age. However, a defined benefit plan is not required under section 411(b)(1)(H) and paragraph (b) of this section to take into account for benefit accrual purposes any year of service completed before an employee becomes a participant in the plan. See paragraph (b)(2) of this section for rules relating to benefit and service limitations that may be imposed by a defined benefit plan.

(iii) *Defined contribution plans.* Section 411(b)(2) and paragraph (c) of this section are not applicable with respect to allocations of employer contributions or forfeitures to the accounts of participants under a defined contribution plan for a plan year beginning before January 1, 1988. However, in the case of a defined contribution plan under which allocations to the accounts of participants for a plan year are determined on the basis of an allocation formula that takes into account service or compensation for the employer during prior plan years, section 411(b)(2) and paragraph (c) of this section are effective for plan years beginning on or after January 1, 1988, with respect to all years of service completed by the participant, including years of service completed before the first plan year beginning on or after January 1, 1988. Accordingly, in the case of a participant who has at least 1 hour of service in a plan year beginning on or after January 1, 1988, a defined contribution plan containing an allocation formula described in the preceding sentence does not satisfy section 411(b)(2) and paragraph (c) of this section with respect to allocations for a plan year beginning on or after January 1, 1988, if the plan disregards, because of the participant's attainment of any age, any year of service completed by the participant. See paragraph (c)(2) of this section for rules relating to limitations on allocations to the accounts of participants that may be imposed by a defined contribution plan.

(iv) *Employee contributions.* In applying paragraph (f)(1)(i), (ii) and (iii) of this section to plan years beginning on or after January 1, 1988, a year of service completed before the first plan year beginning on or after January 1, 1988, will not be treated as being disregarded under a plan on account of a participant's attainment of a specified age solely because such year of service is disregarded under the plan because the participant was not eligible to make voluntary or mandatory employee contributions as well as contributions under a cash or deferred arrangement described in section 401(k)) under the plan for such year. A plan is not required to permit a participant to make voluntary or mandatory employee contributions (as well as contributions under a cash or deferred arrangement described in section 401(k) for a plan year beginning before January 1, 1988, in order to satisfy section 411(b)(1)(H) or (b)(2) or paragraphs (b) of (c) of this section for a plan year beginning on or after January 1, 1988.

(v) *Hour of service.* For purposes of this paragraph (f)(1), one hour service means one hour of service recognized under the plan or required to be recognized under the plan by section 410 (relating to minimum participation standards) or section 411 (relating to minimum vesting standards). In the case of a plan that does not determine service on the basis of hours of service, one hour of service means any service recognized under the plan or required to be recognized under the plan by section 410 (relating to minimum participation standards) or section 411 (relating to minimum vesting standards).

(vi) *Examples.* The provisions of paragraph (f)(1) of this section may be illustrated by the following examples. In each example, assume that the participant completes the hours of service in a plan year required under the plan to accrue a full benefit or receive an allocation for the plan year.

Example (1). Employer X maintains a noncontributory defined benefit plan (that is not a collectively bargained plan) that provides a normal retirement benefit equal to 1% of a participant's average annual compensation for the participant's three consecutive years of highest compensation, multiplied by the participant's years of credited service under the plan. The plan contains no limit on the number of years of credited service taken into account for purposes of determining the normal retirement benefit provided by the plan. The plan uses the calendar year as its plan year. The plan specifies a normal retirement age of 65 and provides (prior to January 1, 1988) that no compensation earned and no service performed by a participant after attainment of normal retirement age will be taken into account in determining the participant's normal retirement benefit. Participant A attains normal retirement age on December 15, 1985. A continues in the full time service of X and has at least 1 hour of service for X during the plan year beginning on January 1, 1988. As of the plan year ending December 31, 1985, A had 35 years of credited service under the plan. In accordance with the plan provisions in effect prior to January 1, 1988, A's service and compensation during the 1986 and 1987 plan years is not taken into account in determining A's normal retirement benefit for those plan years. Beginning on January 1, 1988, the plan provisions that compensation earned and years of service completed after normal retirement age are not taken into account in determining a participant's normal retirement benefit may not be applied to A. Thus, as of the plan year beginning January 1, 1988, A's normal retirement benefit under the plan must be determined without regard to those provisions. Accordingly beginning on January 1, 1988, the plan is required to take into account A's service for X and A's compensation from X during the 1986 and 1987 plan years for purposes of determining A's normal retirement benefit in order to satisfy section 411(b)(1))H) and paragraph (b) of this section.

Example (2). Assume the same facts as in *Example (1)*, except that the plan provides that, in determining a participant's normal retirement benefit under the plan (a) not more than 35 years of credited service will be taken into account and (b) no compensation earned after 35 years of credited service have been completed will be taken into account. Accordingly, the plan is not required to take into account A's service for X or A's compensation from X during the 1986 and 1987 plan years for purposes of determining A's normal retirement benefit in order to satisfy section 411(b)(1)(H) and paragraph (b) of this section.

Example (3). Assume the same facts as in *Example (1)*, except that A retires on December 5, 1987 and does not perform any hours of service for X after A's retirement. Accordingly, the plan is not required to take into account A's service for X and A's compensation from X during the 1986 and 1987 plan years for purposes of determining A's normal retirement benefit in order to satisfy section 411(b)(1)(H) and paragraph (b) of this section.

Example (4). Assume the same facts as in *Example (1)*, except that the plan requires, as a condition to accruing benefits attributable to employer contributions under the plan, that a participant make employee contributions under the plan. The plan provides that a participant is not eligible to make employee contributions in a plan year beginning after the plan year in which the participant attains normal retirement age under the plan. Accordingly, A does not make employee contributions during the 1986 and 1987 plan years and, therefore, does not accrue in those plan years a benefit attributable to employer contributions. The plan is not required to take into account A's service for X and A's compensation from X during the 1986 and 1987 plan years in order to satisfy section 411(b)(1)(H) and paragraph (b) of this section. In addition, the plan is not required to permit A to make employee contributions to the plan for the 1986 and 1987 plan years in order to satisfy section 411(b)(1)(H) and paragraph (b) of this section.

Example (5). Employer Y maintains a profit-sharing plan (that is not a collectively bargained plan). The plan is the only qualified plan maintained by Y and uses the calendar year as its plan year. The formula under the plan for allocating employer contributions and forfeitures to the accounts of participants contains a year of service factor. Pursuant to the allocation formula containing the years of service factor, employer contributions and forfeitures for the plan year are allocated among the accounts of participants on the basis of one unit for each full $200 of compensation of the participant for the plan year and one unit for each year of credited service for Y completed by the participant. The plan contains no limit on the number of years of credited service taken into account for purposes of determining the allocation to the account of a participant for the plan year under the plan's allocation formula. The plan specifies a normal retirement age of 65 and provides (prior to January 1, 1988) that no service performed by a participant in a plan year beginning after attainment of normal retirement age will be taken into account in determining the allocation to the participant's account for a plan year. Participant B attains normal retirement age on December 15, 1985. B continues in the full time service of Y and has at least 1 hour of service for Y during the plan year beginning January 1, 1988. As of the plan year ending December 31, 1985, B had 35 years of credited service under the plan. In accordance with the plan provisions in effect prior to January 1, 1988, B's service during the 1986 and 1987 plan years is not taken into account in determining the allocation of employer contributions and forfeitures to B's account for the 1986 and 1987 plan years. As of the plan year beginning January 1, 1988, the plan provision that years of service in plan years beginning after attainment of normal retirement age are not taken into account in determining the allocation of employer contributions and forfeitures to the accounts of participants may not be applied to B. Thus, the allocation of employer contributions and forfeitures to B's account for the 1988 plan year must be determined under the allocation formula contained in the plan without regard to that provision. Accordingly, the plan is required to take into account B's service for Y during the 1986 and 1987 plan years for purposes of determining the allocation of employer contributions and forfeitures to B's account for the 1988 plan year in order to satisfy section 411(b)(2) and paragraph (c) of this section. However, the plan is not required to provide any additional allocation to B's account under the plan for the 1986 or 1987 plan year in order to satisfy section 411(b)(2) and paragraph (c) of this section.

Example (6). Assume the same facts as in *Example (5)*, except that the plan provides that, in determining the allocation of employer contributions and forfeitures to the account of a participant for a plan year, not more than 35 years of credited service for Y will be taken into account. Accordingly, the plan is not required to take into account B's service for Y during the 1986 or 1987 plan years for purposes of determining the allocation of employer contributions and forfeitures to B's account for the 1988 plan year under the allocation formula contained in the plan.

(2) *Collectively bargained plans.* (i) In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers, ratified before March 1, 1986, section 411(b)(1)(H) and (b)(2) is effective for benefits provided under, and employees covered by, any such agreement with respect to plan years beginning on or after the later of —

(A) January 1, 1988, or

(B) The date on which the last of such collective bargaining agreements terminates (determined without regard to any extension of any such agreement occurring on or after March 1, 1986).

However, notwithstanding the preceding sentence, section 411(b)(1)(H) and (b)(2) shall be effective for benefits provided under, and employees covered by, any agreement described in this paragraph (f)(2)(i) no later than with respect to the first plan year beginning on or after January 1, 1990.

(ii) The effective date provisions of paragraph (f)(1) of this section shall apply in the same manner to plans described in paragraph (f)(2)(i) of this section, except that the effective date determined under paragraph (f)(2)(i) shall be substituted for the effective date determined under paragraph (f)(1) of this section.

(iii) In accordance with the provisions of paragraph (f)(2)(i) of this section, a plan described therein may be subject to different effective dates under section 411(b)(1)(H) and (b)(2) for employees who are covered by a collective bargaining agreement and employees who are not covered by a collective bargaining agreement.

(iv) For purposes of paragraph (f)(2)(i) of this section, the service crediting rules of paragraph (f)(1) of this section shall apply to a plan described in paragraph (f)(2)(i) of this section, except that in applying such rules the effective date determined under paragraph (f)(2)(i) of this section shall be substituted for the effective date determined under paragraph (f)(1) of this section. See paragraph (f)(1)(v) of this section for rules relating to the recognition of an hour of service.

(3) *Amendments to plans.* (i) Except as provided in paragraph (f)(3)(ii) of this section, plan amendments required by section 411(b)(1)(H) and (b)(2) (the applicable sections) shall not be required to be made before the first plan year beginning on or after January 1, 1989, if the following requirements are met—

(A) The plan is operated in accordance with the requirements of the applicable section for all periods before the first plan year beginning on or after January 1, 1989, for which such section is effective with respect to the plan; and

(B) Such plan amendments are adopted no later than the last day of the first plan year beginning on or after January 1, 1989, and are made effective retroactively for all periods for which the applicable section is effective with respect to the plan.

(ii) In the case of a collectively bargained plan described in paragraph (f)(2)(i) of this section that satisfies the requirements of paragraph (f)(3)(i) of this section (as modified by this subdivision (ii)), paragraph (f)(3)(i) shall be applied by substituting for "the first plan year beginning on or after January 1, 1989," the first plan year beginning on or after the later of —

(A) January 1, 1989, or

(B) The date on which the last of such collective bargaining agreements terminate (determined without regard to any extension of any such agreement occurring on or after March 1, 1986).

However, notwithstanding the preceding sentence, section 411(b)(1)(H) and (b)(2) shall be applicable to plans described in this paragraph (f)(3)(ii) no later than the first plan year beginning on or after January 1, 1990.

Par. 6. Section 1.411(c)- is amended by revising paragraph (f)(2) to read as follows:

§1.411(c)-1 Allocation of accrued benefits between employer and employee contributions.

* * * * *

(f) *Suspension of benefits*, etc.***

(2) *Employment after retirement.* Except as permitted by paragraph (f)(1) of this section, a defined benefit plan must make an actuarial adjustment to an accrued benefit the payment of which is deferred past normal retirement age. See, also, section 411(b)(1)(H) (relating to continued accruals after normal retirement age) and §1.411(b)-2.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on April 8, 1988, 8:45 a.m., and published in the issue of the Federal Register for April 11, 1988, 53 F.R. 11876)

Notice of Proposed Rulemaking

INTL-52-86

Information Reporting and Backup Withholding

AGENCY: Internal Revenue Service, Treasury

ACTION: Notice of proposed rulemaking.

SUMMARY: This document provides proposed regulations incorporating certain provisions of the Temporary Employment Tax Regulations relating to information reporting and backup withholding under the Interest and Dividend Tax Compliance Act of 1983 that were published in the FEDERAL REGISTER in question and answer format (Part 35a) on December 20, 1983 (48 FR 56330), January 3, 1984 (49 FR 62), and February 28, 1984 (49 FR 7227), August 22, 1984 (40 FR 33236, 33239) [T.D. 7966, 1984-2 C.B. 324] and August 29, 1984 (49 FR 34340) [T.D. 7972, 1984-2 C.B. 327].

These proposed regulations also incorporate changes to the applicable tax law made by the Interest and Dividend Tax Compliance Act of 1983 (97 Stat. 369), the Tax Reform Act of 1984 (98 Stat. 494), and The Tax Reform Act of 1986 (100 Stat. 2085). These proposed regulations affect payors, brokers, and payees of certain reportable payments and provide them with the guidance necessary to comply with the law.

DATES: Written comments and requests for a public hearing must be delivered or mailed before April 29, 1988. The regulations are proposed to be effective generally with respect to reportable payments made and transactions occurring after [DATE WHICH IS 30 DAYS AFTER DATE OF PUBLICATION OF THIS DOCUMENT AS A TREASURY DECISION IN THE FEDERAL REGISTER].

ADDRESS: Send comments and request for a public hearing to: Commissioner of Internal Revenue, Attention CC:LR:T (INTL-52-86), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains proposed regulations relating to the requirement that certain payments must be reported to the Internal Revenue Service and that, in certain instances, 20 percent of a reportable payment must be deducted and withheld under section 3406 of the Internal Revenue Code of 1954 (26 U.S.C. 3406). This provision was added to the Code by section 104 of the Interest and Dividend Tax Compliance Act of 1983 (Pub. L. 98-67, 97 Stat. 369, 371). These amendments are proposed to be issued under the authority contained in section 3406(a), section 6041(a), section 6042(a), (b), and (c), section 6043, section 6044(a) and (c), section 6045, section 6049(a), (b), (c), and (d), and section 6050A. The temporary regulations contained in Part 35a and proposed to be deleted (§35a.9999-3A, and parts of

§35a.9999-3, §35a.9999-4T, and §35a.9999-5) will remain in effect until superseded by final regulations on this subject.

These regulations modify and expand upon the various information reporting provisions to the extent that they relate to transactions involving foreign persons. The regulations also clarify the application of backup withholding to certain reportable payments. However, these regulations do not address the application of backup withholding to reportable payments of either foreign source dividends or foreign source interest paid outside the United States or to payments made outside the United States by foreign branches of banks, brokers, and payee agents. These subjects are reserved and will be addressed in future proposed regulations.

With respect to information reporting of payments of interest by or to foreign persons, these regulations clarify the information reporting requirements applicable to foreign branches of domestic and foreign banks. Foreign branches of domestic banks generally are required to report payments of interest on deposits held by United States persons. The foreign branches, however, are not required to obtain a Form W-8 in order to treat a payee as other than a United States person; rather, they may rely on documentary evidence in their records (beyond merely a foreign address). The regulations also specify that a foreign branch of a foreign bank is subject to information reporting with respect to deposits of United States persons only if the bank is a U.S.-related person (either a controlled foreign corporation or a person with at least 50 percent effectively connected income for the preceding three years).

The regulations modify current regulations that exempt from information reporting any interest paid on deposits of foreign persons with United States branches of foreign and domestic banks. The Internal Revenue Service has determined that information concerning deposits of individual residents of Canada in United States bank accounts would be of significant use in furthering its compliance efforts. Consequently, these regulations require reporting of interest paid on those deposits to residents of Canada, which provides such information to the United States. However, such interest is not subject to backup withholding. The regulations do not require reporting of deposit interest paid to residents of any other foreign country. If at some future time the Service should determine that extension of the requirement to residents of other foreign countries is appropriate, new proposed regulations proposing such an extension would be issued. Payors may, however, report deposit interest paid to a nonresident alien who is a resident of a country other than Canada.

The regulations expand the reporting provisions of current law to require a custodian or nominee of a United States person to make an information return with respect to foreign source interest collected outside the United States on behalf of such person. However, this requirement does not extend to foreign custodians or nominees unless they are U.S.-related persons.

These regulations also change current regulations by not allowing a payor or broker to avoid the requirement to obtain a Form W-8 simply because it has withheld tax on any amount paid to a payee or a customer.

The rules under section 6042 relating to information reporting of dividends paid by foreign corporations are modified by these regulations to correspond more closely to the rules relating to information reporting of interest paid by such corporations.

These regulations also modify and clarify the information reporting provisions of section 6045 as they relate to transactions effected by foreign offices of brokers. The information reporting requirements generally parallel those applicable to foreign branches of banks. Also, these regulations would require a broker to effect a sale at a foreign office in order for the broker to be able to rely on documentary evidence (rather than a Form W-8) in determining whether a customer is a foreign person with respect to whom no information return is required. Further, the definition of documentary evidence for purposes of establishing a payee's foreign status is clarified and modified prospectively only.

These regulations also propose to change certain regulatory provisions affecting payments by and to United States persons. First, the payment of a capital gain dividend is exempt from reporting under section 6042 because it is not a dividend under section 316. Second, the list of exempt recipients under §1.6049-4(c) has been revised to exclude brokers, nominees, and custodians. Third, the requirements of a statement to the recipient of reportable payments under section 6042, 6044, and 6049 has been revised by adding to the statement the taxpayer identification number of the person filing the form, by changing the wording of the legend, and by updating the separate mailing requirement.

EFFECT OF THE TAX REFORM ACT OF 1984 ON INFORMATION REPORTING

The Tax Reform Act of 1984 amended section 6042 to provide that payments made to exempt recipients (as defined in section 6049(b)(4)) are not subject to information reporting under section 6042. Accordingly, the regulations under section 6042 will be amended to eliminate reporting on exempt recipients identified in regulations under section 6049. Because such payments of dividends are not subject to information reporting, backup withholding will not apply to such payments and dividends. Thus, payments of interest and dividends are afforded the same treatment for purposes of information reporting and backup withholding.

EFFECT OF THE TAX REFORM ACT OF 1986

The Tax Reform Act of 1986 added section 6050N to require information reporting on royalty payments according to the forms or regulations prescribed by the Secretary. The Internal Revenue Service expects to issue regulations under section 6050N. In the meantime, payors and nominees are subject to the reporting requirements under section 6050N according to the forms prescribed by the Secretary.

The Tax Reform Act of 1986 also changed the mailing requirements applicable to the delivery of statements to recipients of dividends, partronage dividends, and interest under sections 6042(c), 6044(e), and 6049(c). The Internal Revenue Service issued guidance to the public on the statement mailing requirement under new law through Notice 87-17, 1987-1 C.B. 454. These proposed rules do not further address the statement mailing requirements under new law and specifically reserve this topic. Accordingly Notice 87-17 continues to apply.

NON-APPLICABILITY OF EXECUTIVE ORDER 12291

The Commissioner has determined that these regulations are not major rules as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required.

REGULATORY FLEXIBILITY ACT

Although this document is a notice of proposed rulemaking which solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

COMMENTS AND REQUEST FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of the Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register. The collection of information requirements contained herein has been submitted to OMB for review under the Paperwork Reduction Act, and comments on them should be sent to the Office of Information and Regulatory Affairs of OMB, Attention: Desk Officer for the Internal Revenue Service, New Executive Office Building, Washington, D.C. 20503. The Internal Revenue Service requests persons submitting comments to OMB to also send copies of the comments to the Service.

* * * * *

Proposed amendments to the regulations.

The proposed amendments to 26 CFR Parts 1, 31, and 35a are as follows:

PART 1—INCOME TAX REGULATIONS

Paragraph 1. The authority for Part 1 continues to read in part:

Authority: 26 U.S.C. 7805 *** Section 1.6042 also issued under 26 U.S.C. 6042(b). Section 1.6044 also issued under 26 U.S.C. 6044(a), (b), and (e). Section 1.6043 also issued under 26 U.S.C. 6043(a) and (b). Section 1.6045 also issued under 26 U.S.C. 6045(a). Section 1.6049 also issued under 26 U.S.C. 6049(a), (b), (c), and (d). Section 1.6050A-1 also issued under 26 U.S.C. 6050A.

Par. 2. Section 1.6041-1 is amended by adding the following new sentences at the end of paragraphs (a)(1) and (2) to read as follows:

§1.6041-1 Return of information as to payments of $600 or more.

(a) *General rule.* (1) *** However, for purposes of section 6041, the term "interest" does not include amounts described in section 6049(b)(2)(C) or (D). For example, an amount paid to an exempt recipient under §1.6049-4 or an amount that is not considered interest under §1.6049-5 is not considered interest for purposes of section 6041. A payment described in subdivision (ii) of this paragraph, except a payment of rent or royalties, shall not include a payment of foreign source income under section 862 if the payee is a foreign person. Unless the payor has actual knowledge that a payee of an amount is a United States person, a payor may treat the payee as a foreign person if the payor receives from the payee the penalties of perjury statement as described in §1.6049-5(g).

(2) *Prescribed form.* *** For the requirement to submit the information required by Form 1099 on magnetic media for payments after December 31, 1983, see section 6011(e) and §301.6011-2 of this chapter (Regulations on Procedure and Administration.)

* * * * *

Par. 3. Section 1.6041-3 is amended by revising paragraph (m) to read as follows:

§1.6041-3 Payments for which no return of information is required under section 6041.

* * * * *

(m) Payments made to employees (other than employees of the United States or any agency thereof) for services performed in Puerto Rico;

* * * * *

Par. 4. Section 1.6041-4 is amended by adding the following new sentence at the end of paragraph (a) to read as follows:

§1.6041-4 Returns of information as to foreign items.

(a) *In general.* *** However, no information return shall be required by this section with respect to the collection of amounts described in section 6049(b)(2)(C) or (D), amounts described in section 6042(b)(2), or amounts exempted from reporting under section 6045 by regulation.

* * * * *

Par. 5. Section 1.6041-7 is amended by revising the section heading and adding a new last sentence to paragraph (a) to read as follows:

§1.6041-7 Magnetic media requirement.

(a) *General.* *** For rules relating to permission to submit the information required by Form 1099 or Form W-2 on magnetic media for payments after December 31, 1983, see section 6011(e) and §301.6011-2 of this chapter (Regulations on Procedure and Administration).

* * * * *

Par. 6. Section 1.6042-2 is amended by—

1. Revising the heading of §1.6042-2,
2. Adding the introductory text of paragraph (a)(1) and revising paragraph (a)(1)(i),
3. Revising paragraph (a)(1)(ii),
4. Removing the reference to "1099M" in the first sentence of paragraph (a)(1)(iii) and adding in its place the reference to "1099",
5. Removing the reference to "1087" in the second sentence of paragraph (a)(4) and inserting "1099" in its place, and deleting the third sentence, and
6. Revising the heading of paragraph (e) and adding a new last sentence to paragraph (e).

These revised and added provisions read as follows:

§1.6042-2 Returns of information as to dividends paid.

(a) *Requirement of reporting*—(1) *In general.* An information return on Form 1099 shall be made under section 6042(a) by—

(i) Every person who makes a payment of dividends (as defined in §1.6042-3) to any other person during a calendar year. The information return shall show the aggregate amount of the dividends, the name, address, and taxpayer identification number of the person to whom paid, the amount of tax deducted and withheld under section 3406 from the dividends, if any, and such other information as required by the forms. An information return is generally not required if the amount of the dividends paid to the other person during the calendar year aggregates less than $10 or if the payment is made to a person who is an exempt recipient described in §1.6049-4(c)(1)(ii), unless the tax imposed by section 3406 is required to be withheld. In the case of any amount subject to backup withholding under section 3406, an information return shall be made unless the amount is refunded by the payor before the due date of the information return in accordance with the regulations under section 3406. For purposes of this paragraph, until such time as the Commissioner determines that it is feasible to permit aggregation of payments on two or more separate stock ownership accounts, and until this paragraph is amended accordingly to provide for reporting on an aggregate basis, the requirement for filing Form 1099 under this section will be met only if a person making payments of dividends to another person on two or more separate stock ownership accounts (regardless of whether all dividends are made on only one class of stock) files a separate Form 1099 with respect to each such stock ownership account as required by this paragraph.

(ii) Every person, except to the extent that he acts as a nominee described in paragraph (a)(1)(iii) of this section, who receives payments of dividends as a nominee on behalf of another person. The information return shall show the aggregate amount of the dividends, the name, address, and taxpayer identification number of the person on whose behalf the dividends are received, the amount of tax deducted and withheld under section 3406 from the dividends, if any, and such other information as required by the forms. An information return is generally not required if the amount of the dividends received on behalf of the other person during the calendar year aggregates less than $10 or if the payment is made to a person who is an exempt recipient described in §1.6049-4(c)(1)(ii), unless the tax imposed by section 3406 is required to be withheld. In the case of any payment of dividends subject to backup withholding under section 3406, however, an information return shall be made unless the amount is refunded by the payor in accordance with the regulations under section 3406 before the due date of the information return. However, the filing of Form 1099 is not required if—

(A) The record owner is required to file a fiduciary return on Form 1041 disclosing the name, address, and identifying number of the actual owner and furnishes Form K-1 to each actual owner containing the information required to be shown on the form, including amounts withheld under section 3406; or

(B) The record owner is a nominee of a banking institution or trust company exercising trust powers, and such banking institution or trust company is required to file a fiduciary return on Form 1041 disclosing the name, address, and identifying number of the actual owner and furnishes Form K-1 to each actual owner containing the information required to be shown on the form, including amounts withheld under section 3406; or

(C) The record owner is a banking institution or trust company exercising trust powers, or a nominee thereof, and the actual owner is an organization exempt from taxation under section 501(a) for which such banking institution or trust company files an annual return and furnishes Form K-1 to each actual owner containing the information required to be shown on the form, including amounts withheld under section 3406

but only if the name, address, and identifying number of the record owner are included on or with the Form 1041 fiduciary return filed for the estate or trust or the annual return for the tax exempt organization.

* * * * *

(e) *Magnetic media requirement.* *** For the requirement to submit the information required by Form 1099 on magnetic media for payments after December 31, 1983, see section 6011(e) and §301.6011-2 of this chapter (Regulations on Procedure and Administration)

Par. 7. Section 1.6042-3 is amended by revising Paragraph (b) to read as follows

§1.6042-3 Dividends subject to reporting.

* * * * *

(b) *Exceptions.* The term "dividend" does not include—

(1) Any amount paid to a person who is not a United States person. An amount is considered to be an amount paid to a person who is not a United States person if the amount is described in subdivision (i), (ii), (iii), or (iv) of this paragraph. If the amount is paid to joint payees, each joint payee must provide the statement described in this paragraph (b)(1)(i) (or other evidence permitted to be received under §1.6042-3(b)(1)). If any joint payee has not provided such statement, the exemption from reporting does not apply. See §1.6049-5(l) for the manner of avoiding keeping backup withholding in such a case.

(i) An amount is described in this subdivision (i) if, unless the payor or middleman has actual knowledge that the payee is a United States person, the payor or middleman receives from the payee the penalties of perjury statement described in §1.6049-5(g) in accordance with the provisions of that paragraph. A statement from a payee that is a partnership must also include a statement under penalties of perjury that the partnership is composed in whole of nonresident aliens and is not engaged in a trade or business in the United States.

(ii) An amount is described in this subdivision (ii) if the amount paid is subject to withholding under 1441 or 1442 (relating to withholding of tax on nonresident aliens or foreign corporations, respectively) by the person making the distribution or payment. Paragraph (c)(2) of §1.6049-5 applies in determining whether a distribution or payment is subject to withholding under section 1441 or 1442.

(iii) An amount is described in this subdivision (iii) if the amount would be subject to withholding under subchapter A of chapter 3 of the Code by the person paying such amount but for the fact that it is exempt from withholding by reason of a tax treaty. Paragraph (c)(3) of §1.6049-5 applies in determining whether a distribution or payment would be subject to withholding but for the provisions of a treaty.

(iv) An amount is described in this subdivision (iv) if withholding is not required under subchapter A of chapter 3 of the Code by reason of paragraph (a) or (f) of § 1.1441-4. Paragraph (c)(4) of §1.6049-5 applies in determining whether withholding is not required by reason of paragraph (a) or (f) of §1.1441-4.

(2) Any amount from sources outside the United States under section 862(a)(2) that is distributed or paid outside the United States by a foreign corporation other than the amount that is collected on behalf of the actual owner and paid by a nominee, custodian or other agent of the actual owner, which agent is either a United States person or a United States-related person under § 1.6049-5(f)(2), unless such actual owner is not a United States person. A determination by a paying, transfer, or other agent of the corporation or by a nominee, custodian, or other agent of the actual owner of whether an amount is distributed or paid by a foreign corporation and as to whether an amount is income from sources outside the United States shall be made for this purpose in accordance with procedures provided in § 1.6049-5(d)(4)(ii). Solely for purposes of paragraph (b)(2) of this section, a nominee, custodian or other agent of the actual owner may treat the actual owner as a person who is not a United States person if the agent of the actual owner has documentary evidence in its records that the actual owner is not a United States person (provided that the agent of the actual owner does not have actual knowledge that the evidence is false). An agent of the actual owner has documentary evidence in its records that actual owner is not a United States person if (i) the agent of the actual owner obtains and has in its records the statement described in §1.6049-5(g), a Form 1001 completed under penalties of perjury, or a Form 4224 completed under penalties of perjury, or (ii) the agent of the actual owner has been provided with documentary evidence (such as a passport, identity credential, or other similar evidence of citizenship and residence) on the basis of which a reasonable person would conclude that the actual owner is not a United States person, and the employee of the agent of the actual owner who has been provided with such evidence signs a separate written statement as part of the records of the account which states that such evidence has been provided and specifies the nature and details of the evidence. The mere fact, however, that the actual owner has provided an address outside the United States is not sufficient evidence for this purpose. For purposes of section 6042 and this section, an amount is considered paid outside the United States by a corporation or its paying agent or by the agent of the actual owner if the corporation or its paying, transfer, or other agent or the agent of the actual owner completes the acts necessary to effect payment outside the United States. A payment is not considered to be made within the United States for purposes of section 6042 and this section by reason of the fact that it is drawn on a United States bank account or by wire or other electronic transfer from a United States account. However, without regard to the location of the account from which the amount is drawn, an amount paid by transfer to an account maintained by the payee or actual owner in the United States or by mail to a United States address is considered to be paid within the United States if the amount is described in subdivision (i) or (ii) of §1.6049-5(j)(1).

(3) A capital gain dividend as defined in section 852(b)(3)(C). A person making a distribution or payment may treat each distribution or payment as a capital gain dividend (as defined in section 852(b)(3)(C)) if the person has received a copy of the notice required by section 852 and the regulations thereunder that designates the amount as a capital gain dividend.

(4) With respect to amounts paid or credited after December 31, 1982, any amount paid or credited to any person described §1.6049-4(c)(1)(ii).

* * * * *

Par. 8. Section 1.6042-4 is amended by revising the heading, by removing the phrase "Form 1099 or 1087" and adding in its place wherever it appears the phrase "Form 1099", and by adding a new sentence at the end of paragraph (a) to read as follows:

§1.6042-4 Statements to recipients of dividend paid before January 1, 1984.

(a) *Requirement.* *** For the requirement to furnish a statement to a recipient of dividend payments made after December 31, 1983, see §1.6042-5.

* * * * *

Par. 9. A new §1.6042-5 is added immediately after §1.6042-4 to read as follows:

§1.6042-5 Official statements to recipients of dividends paid after December 31, 1983.

(a) *Requirement.* Every person filing a Form 1099 under section 6042(a)(1) and §1.6042-2 with respect to dividends paid after December 31, 1983, shall furnish under section 6042(c) and this section to each person whose identifying number is shown on the form a written statement showing the information required by paragraph (b) of this section. The statement shall be furnished to the recipient in the manner required in paragraph (c) of this section.

(b) *Official statement to recipient for dividends paid after December 31, 1983.* Section 6042(c) and paragraph (a) of this section require every person making an information return under section 6042(a) and §1.6042-2(a) to furnish a statement to the recipient. This requirement shall be met by furnishing to the recipient an official Form 1099 for dividends paid after December 31, 1983. The official Form 1099 shall be the form prescribed by the Internal Revenue Service for the respective calendar year. The Form 1099 shall include:

(1) The name, address and taxpayer identification number of the recipient,

(2) The aggregate amount of dividends paid to (or received on behalf of) the recipient,

(3) The amount of tax withheld under section 3406, if any,

(4) The name, address and taxpayer identification number of the person making the return,

(5) A statement, in bold and conspicuous type, informing the recipient that the form contains important tax information that is being furnished to the Internal Revenue Service and that if the recipient is required to file an income tax return, the recipient may be subject to a negligence penalty (as described in section 6653(g)) or other sanction in the event that the income is taxable and the Internal Revenue Service determines that the recipient has not included the income on the recipient's tax return, and

(6) Any other information as required by the form.

A reasonable facsimile (as described in §1.6042-4(b)) of the official Form 1099 will not satisfy the requirement under this section to furnish a statement to any person. A payor, however, may use a form that contains provisions that are substantially similar to those of the official Form 1099 if the payor complies with all applicable revenue procedures relating to substitute Forms 1099. A payor may aggregate all payments of dividends made to a recipient with respect to each separate stock ownership account during a calendar year on one Form 1099.

(c) *Manner of providing the official statement to the recipient.* The official Form 1099 shall be provided to the recipient either in person or by first-class mail. The Form 1099 shall be sent by first-class mail to the recipient at his last known address or personally delivered to the recipient.

(1) *Separate mailing requirement for forms to be filed after December 31, 1984, and on or before October 22, 1986.* With respect to a Form 1099 which is required to be filed after December 31, 1984, and on or before October 22, 1986 (without regard to extensions), a Form 1099 that is mailed to the recipient generally must be furnished separately from any other mail (including the payment subject to reporting) that the payor mails to the recipient. The only items that may be mailed to the recipient with the Form 1099 are—

(i) Statements related to other Forms 1099, Forms 1098, and Forms 5498 (or the account balance on a Form 5498); and

(ii) Any documents relating to a solicitation of the recipient's correct taxpayer identification number (Form W-9) or a solicitation of a Form W-8 or substitute form.

If a payor does not either personally deliver the Form 1099 to the recipient or mail the Form 1099 in a separate first-class mailing to the recipient, the payor shall be considered to have failed to make the statement required under section 6042(c) and will be subject to the penalty under section 6678.

(2) *Statement mailing requirement to be filed after October 22, 1986.* [Reserved]

(d) *Time for furnishing statements.* Each statement required by section 6042(c) and this section shall be furnished to the recipient in accordance with §1.6042-4(c).

(e) *Penalty.* For provisions relating to the penalty provided for failure to furnish a statement under this section, see sections 6722 and 6724(c) and the regulations thereunder (section 6678 for statements required to be furnished before January 1, 1987).

Par. 10. Section 1.6043-2 is amended by removing all reference to "1099L" and adding in its place the reference to "1099".

Par. 11. Section 1.6044-2 is amended by adding two new sentences at the end of paragraph (a)(1) and by revising the heading to paragraph (f) and adding a new first sentence to paragraph (f) to read as follows:

§1.6044-2 Returns of information as to payments of patronage dividends.

(a) *Requirement of reporting*—(1) *In general.* *** The organization is required to make an information return regardless of the amount of the payment if the tax imposed by section 3406 is required to be withheld. Thus, in the case of any amount subject to backup withholding under section 3406 and not refunded by the payor before the due date of the information return in accordance with the regulations under section 3406, an information return shall be made even if the payment is not generally reportable because it is made to an exempt recipient described in §1.6049-4(c)(1)(ii) or the amount paid during the calendar year to the recipient aggregates less than $10.

* * * * *

(f) *Magnetic media requirement.* For the requirement to submit the information required by Form 1099 on magnetic media for payments after December 31, 1983, see section 6011(e) and §301.6011-2 of this chapter (Regulations on Procedure and Administration). ***

Par. 12. Section 1.6044-3 is amended by revising paragraph (c) to read as follows:

§1.6044-3 Amounts subject to reporting.

* * * * *

(c) *Exceptions.* An amount described in paragraph (a) of this section does not include—

(1) Any amount described in §1.6042-3(b), or

(2) With respect to amounts paid or credited after December 31, 1982, any amount paid or credited to any person described in §1.6049-4(c)(1)(ii).

* * * * *

Par. 13. Section 1.6044-5 is amended by revising the heading and by adding a new sentence at the end of paragraph (a) to read as follows:

§1.6044-5 Statements to recipients of patronage dividends made before January 1, 1984.

(a) *Requirement.* *** For the requirement to furnish a statement to a patron with respect to payments made after December 31, 1983, see §1.6044-6.

* * * * *

Par. 14. A new §1.6044-6 is added immediately after §1.6044-5 to read as follows:

§1.6044-6 Official statements to recipients for payments made after December 31, 1983.

(a) *Requirement.* Every cooperative filing a Form 1099 under section 6044(a)(1) and §1.6044-2 with respect to payments made to its patrons after December 31, 1983, shall furnish under section 6044(e) and this section to each patron whose identifying number is shown on the form a written statement showing the information required by paragraph (b) of this section. The statement shall be furnished to the patron in the manner required in paragraph (c) of this section.

(b) *Official statement to recipient for payment made after December 31, 1983.* Section 6044(a) and paragraph (a) of this section require every cooperative making an information return under section 6044(a)(1) and §1.6044-2(a)(1) to furnish a statement to the patron. This requirement shall be met by furnishing to the patron an official Form 1099 for payments made after December 31, 1983. The official Form 1099 shall be the form prescribed by the Internal Revenue Service for the respective calendar year. The Form 1099 shall include:

(1) The name, address and taxpayer identification number of the recipient,

(2) The aggregate amount of payments made to (or received on behalf of) the patron,

(3) The amount of tax withheld under section 3406, if any,

(4) The name, address, and taxpayer identification number of the cooperative making the return,

(5) A statement, in bold and conspicuous type, informing the recipient that the form contains important tax information that is being furnished to the Internal Revenue Service and that, if the recipient is required to file an income tax return, the recipient may be subject to a negligence penalty (as described in section 6653(g)) or other sanction in the event that the income is taxable on the recipient's tax return and the Internal Revenue Service determines that the recipient has not included the income on the recipient's tax return, and

(6) Any other information as required by the form. A reasonable facsimile (as described in §1.6044-5(b)) of the official Form 1099 will not satisfy the requirement under this section to furnish a statement to any patron. A cooperative, however, may use a form that contains provisions that are substantially similar to those of the official Form 1099 if the cooperative complies with all applicable revenue procedures relating to substitute Forms 1099. A cooperative may aggregate all payments under section 6044 to a patron during a calendar year on one Form 1099.

(c) *Manner of providing the official statement to the recipient.* The official Form 1099 shall be provided to the patron either in person or by first-class mail. The Form 1099 shall be sent by first-class mail to the patron at his last known address or personally delivered to the patron.

(1) *Separate mailing requirement for forms to be filed after December 31, 1984, and on or before October 22, 1986.* With respect to a Form 1099 which is required to be filed after December 31, 1984 and on or before October 22, 1986 (without regard to extensions), a Form 1099 that is mailed to the patron generally must be furnished separately from any other mail (including the payment subject to reporting) that the cooperative mails to the patron. The only items that may be mailed to the patron with the Form 1099 are—

(i) Statements related to any other Forms 1099, Forms 1098, and Forms 5498 (or the account balance on a Form 5498); and

(ii) Any documents relating to a solicitation of the patron's correct taxpayer identification number (Form W-9) or the solicitation of a Form W-8 or substitute form.

If a cooperative does not either personally deliver the Form 1099 to the patron or mail the Form 1099 in a separate first-class mailing to the patron, the cooperative shall be considered to have failed to make the statement under section 6044(e) and will be subject to the penalty under section 6678.

(2) *Statement mailing requirement for forms to be filed after October 22, 1986.* [Reserved]

(d) *Time for furnishing statements.* Each statement required by section 6044(e) and this section shall be furnished to the patron any time during the year of the payment and on or before January 31, of the following year, but no statement may be furnished before the final payment has been made for the calendar year.

(e) *Penalty.* For provisions relating to the penalty provided for failure to furnish a statement under this section, see sections 6722 and 6724(c) and the regulations thereunder.

Par. 15. Section 1.6045-1 is amended by—

1. Revising paragraph (a)(1),

2. Adding new paragraph (a)(14),

3. Redesignating paragraph (c)(5)(ii) as paragraph as paragraph (c)(5)(iii) and adding a new paragraph (c)(5)(ii),

4. Revising paragraph (g).

These added and revised provisions read as follows:

§1.6045-1 Returns of information of brokers and barter exchanges.

(a) Meaning of terms. ***

(1) (i) Except as provided in paragraph (a)(1)(ii), the term "broker" means—

(A) With respect to a sale effected at an office inside the United States, a person, other than a person who is required to report a transaction under section 6043, who in the ordinary course of a trade or business during the calendar year, stands ready to effect sales to be made by others, and includes an obligor that regularly issues and retires its own debt obligations or a corporation that regularly redeems its own stock; and

(B) With respect to a sale (including a redemption or retirement) effected at an office outside the United States, a person described in a subdivision (i) of this paragraph (a)(1) but only if such person is either a United States person or a

United States-related person as defined in §1.6049-5(f)(2).

(ii) With respect to the redemption or retirement by an international organization of an obligation issued by it, the term "broker" does not include an international organization (as described in §1.6049-4(c)(1)(ii)(G)), of which the United States is a member and which enjoys immunity with respect to the inviolability of its archives pursuant to an international agreement having full force and effect in the United States (or its paying, transfer, or other agent).

* * * * *

(14) For transactions occurring on September 3, 1982, and thereafter, the term "person" includes any governmental unit and any agency or instrumentality thereof. Under section 6652 and 6722 and the regulations thereunder, no penalty shall be imposed on a person defined under section 6045(c)(4)) for failing to file a return or furnish a statement under section 6045 for payments paid or credited before January 1, 1985.

* * * * *

(c) *Reporting by brokers*—***

* * * * *

(5) *Form of reporting for regulated futures contracts*—(i) *In general*. ***

(ii) *Determination of profit or loss from foreign currency contracts.* A broker effecting closing transaction in foreign currency contracts (as defined in section 1256(g)) shall report information with respect to such contract in the manner prescribed in paragraph (c)(5)(i) of this section. If a foreign currency contract is closed by making or taking delivery, the net realized profit or loss for purposes of paragraph (c)(5)(i)(*b*) of this section is determined by comparing the contract price to the spot price for the contract currency at the time and place specified in the contract. If a foreign currency contract is closed by entry into an offsetting contract, the net realized profit or loss for purposes of paragraph (c)(5)(i)(*b*) of this section is comparing the contract price to the price of the offsetting contract. The net unrealized profit or loss in a foreign currency contract for purposes of paragraph (c)(5)(i)(*c*) and (*d*) of this section is determined by comparing the contract price to the broker's price for similar contracts at the close of business of the relevant year.

* * * * *

(g) *Exempt foreign persons*—(1) *Brokers*—(i) *In general.* No return of information is required by a broker with respect to a customer who is considered to be an exempt foreign person under this paragraph. Unless it has actual knowledge that a customer is a United States person, a broker may treat a customer as an exempt foreign person if—

(A) With respect to a sale effected at an office of the broker inside the United States, the broker obtains the statement described in paragraph (g)(3) of this section; or

(B) With respect to a sale effected at an office of the broker outside the United States by a United States person or a United States-related person under §1.6049-5(f)(2), either the broker has documentary evidence in its records that the customer is not a United States person or the broker is not acting as a custodian, nominee, or other agent of the payee and the sale is described in paragraph (g)(1)(ii) of this section.

(ii) *Exception for the redemption or retirement of certain stock yielding foreign source dividends or certain obligations issued by foreign persons or targeted to foreign persons.* A sale is described in this subdivision if it is the redemption or retirement of an obligation or stock effected at an office of the broker outside the United States by an issuer (or its paying or transfer agent); and the interest or dividend on the obligation or stock is described in paragraph (g)(1)(ii)(A), (B), or (C) of this section.

(A) Any interest paid with respect to the obligation is described in—

(*1*) §1.6049-5(c)(6) with respect to a foreign-targeted registered obligation as defined in §1.6049-5(j)(4) or a foreign-targeted bearer obligation (an obligation not in registered form within the meaning given such term by section 163(f)),

(*2*) §1.6049-5(d)(3), or

(*3*) §1.6049-5(e)(2)(i) or (ii).

(B) Any original issue discount paid with respect to the obligation is described in §1.6049-5(c)(5)(ii).

(C) Any dividend paid with respect to the stock is described in §1.6042-3(b)(1).

(iii) *Special rules*—(A) *Documentary Evidence.* A broker has documentary evidence in its records that the customer is not a United States person if (*1*) the broker obtains and has in its records the statement described in paragraph (g)(3) of this section, Form 1001 completed under penalties of perjury, or Form 4224 completed under penalties of perjury, or (*2*) the broker has been provided with documentary evidence (such as a passport, identity credential, or other similar evidence of citizenship and residence) on the basis of which a reasonable person would conclude that the customer is not a United States person, and the employee of the broker who has been provided with such evidence signs a separate written statement as part of the records of the account which states that such evidence has been provided and specifies the nature and details of the evidence. The mere fact, however, that a customer has provided an address outside the United States is insufficient evidence to establish for this purpose that the customer is not a United States person.

(B) *Place of effecting sale.* (*1*) *Sale outside the United States.* For purposes of this section and except as provided in subdivision (*2*) of this paragraph (g)(1)(iii)(B), a sale is considered to be effected by a broker at an office outside the United States if, in accordance with instructions directly transmitted to such office from outside the United States by the broker's customer, the office completes the acts necessary to effect the sale outside the United States. The acts necessary to effect the sale may be considered to have been completed outside the United States without regard to whether—

(*i*) Pursuant to instructions from an office of the broker outside the United States, an office of the same broker within the United States undertakes one or more steps of the sale in the United States; or

(*ii*) The gross proceeds of the

sale are paid by a draft drawn on a United States bank account or by a wire or other electronic transfer from a United States account.

(*2*) *Sale inside the United States.* Notwithstanding the rules of subdivision (*1*) of this paragraph (g)(1)(iii)(B), a sale is considered to be effected by a broker at an office inside the United States if either—

(*i*) The customer has opened an account with a United States office of that broker,

(*ii*) The customer has transmitted instructions concerning this and other sales to the foreign office of the broker from within the United States by mail, telephone, electronic transmission or otherwise (unless the transmissions from the United States have taken place in isolated and infrequent circumstances),

(*iii*) The gross proceeds of the sale are paid to the customer by a transfer of funds into an account (other than an international account as defined in §1.6049-5(j)(4)) maintained by the customer in the United States or mailed to the customer at an address in the United States.

(*iv*) The confirmation of the sale is mailed to a customer at an address in the United States, or

(*v*) An office of the same broker within the United States negotiates the sale with the customer or receives instructions with respect to the sale from the customer.

(2) *Barter exchanges.* No return of information is required by a barter exchange with respect to a client or member who is considered to be an exempt foreign person under this paragraph. Unless is has actual knowledge that a client or member is a United States person, a barter exchange may treat the client or member as an exempt foreign person if the barter exchange obtains the statement described in paragraph (g)(3) of this section in accordance with the provisions of that paragraph, except that paragraph (g)(3)(v) of this section shall not apply to barter exchanges.

(3) *Penalties of perjury statement*—(i) *In general.* Except as provided in paragraph (g)(3)(vi) of this section, the broker (or barter exchange) must receive a statement, signed by the customer (or client or member) under penalties of perjury certifying that—

(A) The customer (or client or member) is not a United States person, or in the case that the customer (or client or member) is an individual, that he is neither a citizen nor a resident of the United States;

(B) In the case that the customer (or client or member) is an individual, that the customer (or client or member) has not been, and at the time the statement is furnished reasonably expects not to be, present in the United States for a period aggregating 183 days or more during the calendar year; and

(C) The customer (or client or member) is not, and at the time the statement is furnished reasonably expects not to be, engaged in a trade or business within the United States with respect to which any gain derived from sales effected by the broker (or barter exchange) during the calendar year is effectively connected.

The statement must also contain the name of the customer (or client or member), the address of customer (or client or member), and the taxpayer identification number (if any) of the customer (or client or member). The address provided for an individual shall be that of his permanent residence; the address provided for a partnership or corporation shall be the address of its principal office; and the address provided for a trust or an estate shall be the address of the permanent residence or principal office of any fiduciary of the trust or estate. The statement may be made, at the option of the customer (or client or member), on a Form W-8 or on a form prepared by the broker (or barter exchange) which is substantially similar to Form W-8. Blank copies of Form W-8 will be supplied to broker upon request to the district director.

(ii) *Who may sign statement.* The statement described in paragraph (g)(3)(i) may be signed by any person who is authorized to sign a declaration under penalties of perjury on behalf of the customer (or client or member) as described in section 6061 and the regulations thereunder.

(iii) *When statement must be received and retention.* Except as otherwise provide in paragraph (g)(3)(v) of this section, the statement must be received by the broker (or barter exchange) in the calendar year in which a sale is effected or in either of the preceding 2 calendar years. The broker (or barter exchange), however, may require the statement from the customer (or client or member) each time it effects a transaction on behalf of the customer (or client or member). The broker (or barter exchange) shall retain the statement for at least 4 years following the end of the last calendar year during which the transaction to which the statement relates is effected. If the information provided on the statement changes during the period to which the statement relates, the customer (or client or member) shall notify the broker (or barter exchange) in writing within 30 days of such change.

(iv) *Joint account.* If a transaction is effected with respect to a joint account with a broker (or barter exchange), the broker (or barter exchange) must receive the statement described in paragraph (g)(3)(i) (or other evidence permitted to be received under §1.6045-1) from each joint owner. If a joint owner is a United States person, the transaction is not exempt from reporting under paragraph (g)(1). See paragraph (g)(3)(vi) of this section for the statement required from a customer (or client or member) who is a United States person.

(v) *Special rule prior to January 1, 1985.* With respect to a brokerage relationship that is not a post-1983 brokerage account (as described in section 3406 and the regulations thereunder), the broker is not required to obtain the statement described in paragraph (g)(3)(i) of this section before January 1, 1985, if—

(A) The broker sent a separate mailing to the customer on or before December 31, 1983, requesting the statement (or the broker sent a nonseparate mailing on or before December 31, 1983, requesting the statement and sent a separate mailing requesting the statement on or before March 31, 1984),

(B) The broker sent an additional mailing (which may be a nonseparate mailing) during calendar year 1984 requesting the statement, and

(C) The broker has documentary evidence in its records that the customer is an exempt foreign person in accordance with A-1 of §35a.9999-4T published at 49 FR 33237 on August 22, 1984. [In the final regulations, the text of the rule in A-1 will be inserted in this paragraph.]

The mailing described in paragraph (g)(3)(v)(A) and (B) of this section must be sent by first-class mail, or by airmail if sent to a foreign address, and must contain a notice describing the penalties of perjury statement described in paragraph (g)(3)(i) of this section and advising the customer that backup withholding under section 3406 may commence if the statement is not provided. The broker must also provide a reply envelope and a form on which the customer may make the statement described in paragraph (g)(3)(i) of this section. A separate mailing, for purposes of this paragraph (g)(3)(v), is a mailing that contains only the information described in this paragraph and, at the option of the broker, information relating to the solicitation of a taxpayer identification number. With respect to mail-hold accounts and accounts with respect to which the last-known address of the customer is incorrect, the broker will be considered to have satisfied the requirements of paragraph (g)(3)(v)(A) and (B) of this section if the broker handles the mailings in the same manner that the broker handles other correspondence with the customer. A broker may also satisfy the requirements of this paragraph (g)(3)(v)(A) and (B) if the mailings are delivered to the customer by personal delivery or intra-office mail, provided they are delivered by the same method used generally by the broker in delivering account information and other correspondence to the customer.

(vi) *Exception*. A broker (or barter exchange) is not required to obtain the statement described in paragraph (g)(3)(i) of this section from a customer (or client or member) if the customer (or client or member) has provided the broker (or barter exchange) with a Form W-9 (or acceptable substitute) or if the broker (or barter exchange) may treat the customer (or client or member) as an exempt recipient without receiving a Form W-9 or an acceptable substitute from the customer.

(4) *Examples*. The application of the provisions of paragraph (g) of this section may be illustrated by the following examples:

Example (1). FC is a foreign corporation that is not engaged in a trade or business in the United States during the calendar year. FC regularly issues and retires its own debt obligations. FP is a foreign corporation that is not a United States-related person under §1.6049-5(f)(2). A is an individual whose residence address is inside the United States. A holds a bond issued by FC in registered form within the meaning of section 163(f) and the regulations thereunder and listed on the New York Stock Exchange. Interest on the bond is paid outside the United States. The bond is retired by FP, the designated paying agent of FC and not the agent of A. FP mails the proceeds to A at A's United States address. The sale would be considered to be effected at an office outside the United States under §1.6045-1(g)(1)(iii)(B)(*1*) except that the proceeds of the sale are mailed to a United States address. The sale is considered to be effected at an office of the broker inside the United States under §1.6045-1(g)(1)(iii)(B)(*2*). FC and FP are brokers under §1.6045-1(a)(1)(i)(A). FC is not required to report the payment because, under §5f.6045-1(c)(3)(ii) (the multiple broker exception), FC is not the broker responsible for paying the holder redeemed or retired, or crediting the gross proceeds on the sale to such holder's account. Under paragraph (g)(1)(i)(A) of this section, FP may not treat A as an exempt foreign person and must make an information return under section 6045 with respect to the retirement of the FC bond, unless FP obtains the statement described in paragraph (g)(3) of this section and does not have actual knowledge that A is a United States person.

Example (2). The facts are the same as in Example (1) except that FP mails the proceeds to A at an address outside the United States. Under §1.6045-1(g)(1)(iii)(B)(*1*), the sale is considered to be effected at an office of the broker outside the United States. Under §1.6045-1(a)(1)(i)(B), neither FC nor FP is a broker with respect to the retirement of the FC bond. Therefore, neither is required to make an information return under section 6045.

Example (3). The facts are the same in Example (2) except that FP is also the agent of A. The result is the same as in Example (2).

Example (4). The facts are the same as in Example (1) except that the registered bond held by A was issued by DC, a domestic corporation, and FP mails the proceeds to A at an address outside the United States. DC regularly issues and retires its own debt obligations. Interest on the bond is neither portfolio interest on a foreign-targeted registered obligation described in §1.6049-5(c)(6) nor interest described in §1.6049-5(e)(2)(ii). The sale is considered to be effected at an office outside the United States under §1.6045-1(g)(1)(iii)(B)(*1*). DC is a broker under §1.6045-1(a)(1)(i)(B). DC is not required to report the payment under the multiple broker exception. FP is not required to make an information return under section 6045 because FP is not a broker.

Example (5). The facts are the same as in Example (4) except that FP is also the agent of A. DC is a broker under §1.6045-1(a)(1)(i)(B). DC is not required to report under the multiple broker exception. FP is not required to make an information return under section 6045 because FP is not a broker.

Example (6). The facts are the same as in Example (4) except that the bond is retired by DP, the designated paying agent of DC and not the agent of A. DP is a United States person or a United States-related person. DC is a broker under §1.6045-1(a)(1)(i)(B). DC is not required to report under the multiple broker exception. DP is a broker under §1.6045-(a)(1)(i)(B) and therefore is required to make an information return under section 6045 unless DP obtains the documentary evidence described in paragraph (g)(1)(iii) of this section and does not have actual knowledge that the customer is a United States person.

Par. 16. Section 1.6049-4 is amended by:

1. Removing the phrase "section 3451" each place it appears and adding in its place the phrase "section 3406";

2. Revising paragraph (b)(1);

3. Adding two new sentences after the last sentence of paragraph (b)(2);

4. Revising paragraph (b)(3);

5. Revising paragraph (c)(1)(i) and (ii), redesignating paragraph (c)(1)(iii) as paragraph (c)(1)(iv), and adding a new paragraph (c)(1)(iii);

6. Revising the introductory text and the first and second examples of paragraph (c)(1)(iv) as redesignated;

7. Removing the reference to "§1.6049-5(c)" in paragraph (d)(2) and adding in its place the reference to "§1.6049-5(k)";

8. Revising the caption of paragraph (d)(7) and adding a new second sentence to paragraph (d)(7);

9. Removing the reference to "§1.6049-5(b)(1)(ii)" in paragraph (d)(8) and adding in its place the reference to "§1.6049-5(b)(2)";

10. Revising the reference to paragraph (d)(10)(i) in paragraph (d)(9)(ii) to read "(d)(9)(i)";

11. Removing the reference to "paragraph (c)(1)(ii)(K)" in paragraph (f)(4)(i) and adding in its place the reference to "paragraph (c)(1)(ii)(M)", by deleting the last two sentences of paragraph (f)(4)(i), and by adding two new sentences in their place;

12. Revising the last sentence of the *Example* in paragraph (f)(4)(ii).

These revised and added provisions read as follows:

§1.6049-4 Return of information as to interest paid and original issue discount includible in gross income after December 31, 1982.

* * * * *

(b) *Information to be reported*—(1) *Interest payments.* Except as provided in paragraph (b)(3) of this section, in the case of a payment of interest, other than original issue discount treated as interest under §1.6049-5(k) and other than amounts described in §1.6049-5(e)(2), an information return on Form 1099 shall be made for the calendar year showing the aggregate amount of the payments, the name, address, and taxpayer identification number of the person to whom paid, the amount of tax deducted and withheld under section 3406 from the payments, if any, and such other information as required by the forms. In the case of interest described in §1.6049-5(e)(2), the payor shall make an information return on Form 1042S for the calendar year showing the aggregate amount of the payments, the name, address of the permanent residence, and taxpayer identification number, if any, of the person to whom paid, and such other information as required by the form and shall transmit the information return at the time and in the manner prescribed by §1.1461-2. The payor shall also furnish to such person a written statement showing the information required by §1.6049-6(e)(6). An information return is generally required only if the amount of interest aggregates $10 or more and if the payment is made to a person other than an exempt recipient described in §1.6049-4(c)(1)(ii), unless the tax imposed by section 3406 is required to be withheld. In the case of any amount subject to backup withholding under section 3406, however, an information return shall be made unless the amount is refunded by the payor before the due date of the information return in accordance with the regulations under section 3406.

* * * * *

(2) *Original issue discount.* *** In the case of payments of original issue discount described in §1.6049-5(e)(2), an information return shall be made on Form 1042S for the calendar year showing the aggregate amount of the payments, the name, address of the permanent residence, and taxpayer identification number, if any, of the person to whom paid, and such other information as required by the forms and shall be transmitted as the form and instruction require. The person to whom the original issue discount is paid shall be furnished with a written statement showing the information required by §1.6049-6(e)(6).

(3) *Returns made by middleman*—(i) *In general.* Every person acting as a middleman (as defined in paragraph (f)(4) of this section) shall make an information return for the calendar year. In the case of interest payments (other than original issue discount and other than interest described in §1.6049-5(e)(2)), the information return shall be made on Form 1099 and shall show the aggregate amount of the interest, the name, address, and taxpayer identification number of the person on whose behalf received, the amount of tax withheld under section 3406, if any, such other information as required by the forms. In the case of interest described in §1.6049-5(e)(2), the middleman shall make an information return on Form 1042S for the calendar year showing the aggregate amount of the payments, the name, address of the permanent residence, and taxpayer identification number, if any, of the person on whose behalf received, and such other information as required by the form and shall transmit the information return at the time and in the manner prescribed by §1.1461-2. The middleman shall also furnish to such person a written statement showing the information required by §1.6049-6(e)(6). In the case of original issue discount, the information return shall show the information required to be shown for the person on whose behalf received, as described in paragraph (b)(2) of this section. See §1.6049-5(k) to determine whether a middleman is required to make an information return with respect to original issue discount. A middleman shall make an information return regardless of whether the middleman receives a Form 1099 or Form 1042S. A middleman shall not be required to make an information return if the payment of interest aggregates less than $10 or if the payment is made to an exempt recipient described in paragraph (c)(1)(ii) of this section, unless the amount is withheld upon under section 3406. In the case of any amount subject to backup withholding under section 3406, however, an information return shall be made unless the amount is refunded by the middleman in accordance with the regulations under section 3406 before the due date of the information return.

(ii) *Forwarding of interest coupons and original issue discount obligations.* In the case of a middleman who, from within the United States, forwards an interest coupon or discount obligation on behalf of a payee for presentation, collection or payment outside the United States, the middleman shall make an information return on Form 1099 for the calendar year showing, in the case of an interest coupon, the information required under paragraph (b)(3)(i) and, in the case of a discount obligation, information required under paragraph (b)(2). For purposes of paragraph (b)(3)(ii), a middleman is considered to forward an interest coupon or discount obligation on behalf of a payee for presentation, collection or payment outside the United States if the middleman forwards the coupon or obligations outside the United States on or after the date when the payee is entitled to be paid or at an earlier date if within 90 days of such date or if the middleman has actual knowledge that the coupon or obligation is being forwarded outside the United States for presentation, collection, or payment outside the United States.

Example. Individual F, who is entitled to payment on an interest coupon, instructs an office of Bank M in the United States to forward the coupon to Bank N for collection by Bank N outside the United States. Bank M in the United States forwards the interest coupon to Bank N outside the United States. Bank M is required to make an information return for the calendar year under §1.6049-4(b)(3)(ii) showing the aggregate amount of the interest coupon forwarded, the name, address of the permanent residence, and the taxpayer identification number, if any, of Individual F and such other information as the form requires.

* * * * *

(c) *Information returns not required*—(1) *Payment to exempt recipient*—(i) *In general.* No information return is required with respect to any payment made to an exempt recipient described in paragraph (c)(1)(ii) of this section unless such payment is made by a person required to make a return by paragraph (a)(2)(i) of this section (relating to persons who backup withhold under section 3406). Thus, a person who backup withholds under section 3406 and does not refund the amount withheld pursuant to the regulations under section 3406 is required to make an information return regardless of whether the payee is an exempt recipient in paragraph (c)(1)(ii) of this section.

(ii) *Exempt recipient defined.* The term "exempt recipient" means any person described in this paragraph (c)(1)(ii)(A) through (N). An exempt recipient is generally exempt from information reporting without filing a certificate claiming exempt status unless the provisions of this paragraph (c)(1)(ii) require a payee to file a certificate. A payor may in any case require a payee not otherwise required to file a certificate under this paragraph (c)(1)(ii) to file a certificate as a person who is not an exempt recipient. See section 3406 and the regualtions thereunder for the provisions relating to the certificate a payee may file to claim exempt status and the requirement that a payee described in this paragraph (c)(1)(ii) include such payee's taxpayer identification number on the certificate in order to make the certificate effective.

(A) *Corporation.* A corporation, as defined in section 7701(a)(3), whether domestic or foreign, is an exempt recipient. In addition, the term "corporation" includes a pool, syndicate, partnership, or unincorporated association, any of which is composed exclusively of corporations described in this paragraph, but only if the pool, syndicate, partnership, or unincorporated association files a certificate with the payor claiming exempt status because it is composed exclusively of corporations. Except for the preceding sentence, a payor may treat a payee as a corporation (and, therefore, as an exempt recipient) without requiring a certificate provided that—

(*1*) The name of the payee contains one of the following unambiguous expressions of corporate status: Incorporated, Inc., Corporation, Corp., or P.C., but not Company or Co.,

(*2*) The name of the payee contains the term "insurance company", "indemnity company", "reinsurance company", or "assurance company".

(*3*) The payee is a foreign entity whose name contains any unambiguous expression of corporate status that the Commissioner so designates by ruling, or

(*4*) The payee is known to the payor to be a corporation through a corporate resolution or similar document on file with the payor clearly indicating corporate status.

(B) *Tax exempt organization*—(*1*) *In general.* Any organization which is exempt from taxation under section 501(a) is an exempt recipient. A custodial account under section 403(b)(7) shall be considered an exempt recipient under this paragraph. A payor may treat an organization as an exempt recipient under this paragraph without requiring a certificate if the organization's name is listed in the compilation by the Commissioner of organizations for which a deduction for charitable contributions is allowed, if the name of the organization contains an unambiguous indication that it is a tax exempt organization, or if the organization is known to the payor to be a tax exempt organization.

(*2*) *Examples.* The application of the provisions of paragraph (c)(1)(ii)(B) of this section may be illustrated by the following examples:

Example (1). The following persons maintain accounts at M Bank: N College, O University, P Church. M may treat N, O, and P as exempt recipients without requiring a certificate because the names of the organizations contain an unambiguous indication that they are tax exempt organizations.

Example (2). Q is listed in the current edition of Internal Revenue Service publication 78 as an organization for which deductions are permitted for charitable contributions under section 170(c). Such listing has not been revoked by an announcement published in the Internal Revenue Bulletin. A payor may treat Q as an exempt recipient.

Example (3). Employer R maintains a section 403(b)(7) custodial account with Regulated Investment Company S on behalf of R's employees. S may treat the account as an exempt recipient.

(C) *Individual retirement plan.* An individual retirement plan as defined in section 7701(a)(37) is an exempt recipient. A payor may treat any such plan of which it is the trustee or custodian as an exempt recipient under this paragraph without requiring a certificate.

(D) *United States.* The United States Government and any wholly-owned agency or instrumentality thereof are exempt recipients. A payor may treat a person as an exempt recipient under this paragraph without requiring a certificate if the name of such person reasonably indicates it is described in this paragraph.

(E) *State*—(*1*) In general. A State, the District of Columbia, a possession of the United States, a political subdivision of any of the foregoing, wholly-owned agency or instrumentality of any one or more of the foregoing, and a pool or partnership composed exclusively of any of the foregoing are exempt recipients. A payor may treat a person as an exempt recipient under this paragraph without requiring a certificate if the name of such person reasonably indicates it is described in this paragraph or if such person is known generally in the community to be a State, the District of Columbia, a possession of the United States or a political subdivision or a wholly-owned agency or instrumentality of any one or more of the foregoing.

(*2*) *Example.* The application of the provisions of paragraph (c)(1)(ii)(E) of this section may be illustrated by the following example:

Example. The following persons maintain an account at R Bank: Town of S and County of T. R may treat S and T as exempt recipients.

(F) *Foreign government*—(*1*) *In general.* A foreign government, a political subdivision of a foreign government, and any wholly-owned agency or instrumentality of either of the foregoing are exempt recipients. A payor may treat a foreign government or a political subdivisions thereof as an exempt recipient under this paragraph without requiring a certificate provided that its name reasonably indicates that it is a foreign government or provided that it is known to the payor to be a foreign government or a political subdivision thereof.

(*2*) *Example.* The application of the provisions of paragraph (c)(1)(ii)(F) of this section may be illustrated by the following example:

Example. The Government of V maintains an account of U Bank. U may treat V as an exempt recipient.

(G) *International organization.* An international organization and any wholly-owned agency or instrumentality thereof are exempt recipients. The term "international organization" shall have the meaning ascribed to it in section 7701(a)(18) and includes the following organizations:

(*1*) African Development Fund,

(*2*) Asian Development Bank,

(*3*) Caribbean Commission,

(*4*) Caribbean Organization,

(*5*) Customs Cooperation Council,

(*6*) European Space Research Organization,

(*7*) Food and Agriculture Organization,

(*8*) Great Lakes Fishery Commission,

(*9*) Inter-American Defense Board,

(*10*) Inter-American Development Bank,

(*11*) Inter-American Institute of Agriculture Sciences,

(*12*) Inter-American Statistical Institute,

(*13*) Inter-American Tropical Tuna Commission,

(*14*) Intergovernmental Committee for European Migration,

(*15*) Intergovernmental Maritime Consultative Organization,

(*16*) International Atomic Energy Agency,

(*17*) International Bank for Reconstruction and Development (World Bank),

(*18*) International Boundary and Water Commission,

(*19*) International Centre for Settlement of Investment Disputes,

(*20*) International Civil Aviation Organization,

(*21*) International Coffee Organization,

(*22*) International Cotton Advisory Committee,

(*23*) International Cotton Institute,

(*24*) International Criminal Police Organization,

(*25*) International Development Association,

(*26*) International Fertilizer Development Center,

(*27*) International Finance Corporation,

(*28*) International Food Policy Research Institute,

(*29*) International Hydrographic Bureau,

(*30*) International Joint Commission—United States and Canada,

(*31*) International Labor Organization,

(*32*) International Maritime Satellite Organization,

(*33*) International Monetary Fund,

(*34*) International Pacific Halibut Commission,

(*35*) International Secretariat for Volunteer Service,

(*36*) International Telecommunication Union,

(*37*) International Telecommunication Satellite Organization,

(*38*) International Wheat Advisory Committee (International Wheat Council),

(*39*) Lake Ontario Claims Tribunal,

(*40*) Multinational Force and Observers,

(*41*) North Atlantic Treaty Organization,

(*42*) Organization for Economic Cooperation and Development,

(*43*) Organization of African Unity,

(*44*) Organization of American States (including Pan American Union),

(*45*) Pan American Health Organization,

(*46*) Pan American Sanitary Bureau,

(*47*) Preparatory Commission of the International Atomic Energy Agency,

(*48*) South Pacific Commission,

(*49*) Southeast Asian Treaty Organization,

(*50*) United International Bureaux for the Protection of Intellectual Property,

(*51*) United Nations,

(*52*) United Nations Educational, Scientific, and Cultural Organization,

(*53*) Universal Postal Union,

(*54*) World Health Organization,

(*55*) World Intellectual Property Organization,

(*56*) World Meteorological Organization, and

(*57*) World Tourism Organization.

A payor may treat any of the foregoing and any other organization designated as an international organization by executive order (pursuant to 22 U.S.C. section 288 to 288f) as an exempt recipient without requiring a certificate.

(H) *Foreign central bank of issue.* A foreign central bank of issue is an exempt recipient. A foreign central bank of issue is a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency. See §1.895-1(b)(1). A payor may treat a person as a foreign central bank of issue (and, therefore, as an exempt recipient) without requiring a certificate provided that such person is known generally in the financial community as a foreign central bank of issue.

(I) *Securities or commodities dealer*—(*1*) *In general.* A dealer in securities or commodities registered as such under the laws of the United States or a State is an exempt recipient. A payor may treat a dealer as an exempt recipient under this paragraph without requiring a certificate if the person is known generally in the investment community to be a dealer meeting the requirements set forth in the paragraph.

(2) *Examples.* The application of the provisions of paragraphs (c)(1)(ii)(I) of this section may be illustrated by the following examples:

Example (1). X advertises that purchases of securities may be made through it and is known generally in the investment community as a registered broker-dealer. A payor may treat X as an exempt recipient.

Example (2). Z is listed as a member firm in the most recent publication of members of the National Association of Securities Dealers, Inc. A payor may rely on such listing in treating Z as an exempt recipient.

(J) *Real estate investment trust.* A real estate investment trust, as defined in section 856 and §1.856-1, is an exempt recipient. A payor may treat a person as a real estate investment trust (and, therefore, as an exempt recipient) without requiring a certificate if the person is known generally in the investment community as a real estate investment trust.

(K) *Entity registered under the Investment Company Act of 1940.* An entity registered at all times during the taxable year under the Investment Company Act of 1940, as amended (15 U.S.C. section 80a-1 to 89a-52), is an exempt recipient. An entity that is created during the taxable year will be treated as meeting the registration requirement of the preceding sentence provided that such entity is so registered at all times during the taxable year for which such entity is in existence. A payor may treat such an entity as an exempt recipient under this paragraph without requiring a certificate if the entity is known generally in the investment community to meet the requirements of the preceding sentence.

(L) *Common trust fund.* A common trust fund, as defined in section 584(a), is an exempt recipient. A payor may treat the fund as an exempt recipient without requiring a certificate provided that its name reasonably indicates that it is a common trust fund or provided that it is known to the payor to be a common trust fund.

(M) *Financial institution.* A financial institution such as a bank, mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, industrial loan association or bank, or other similar organization is an exempt recipient. A payor may treat any person described in the preceding sentence as an exempt recipient without requiring a certificate if the person's name reasonably indicates it is described in the preceding sentence.

(N) *Trust.* A trust which is exempt from tax under section 664(c) (*i.e.*, a charitable remainder annuity trust or a charitable remainder unitrust) or is described in section 4947(a)(1) (relating to certain charitable trusts) is an exempt recipient. A payor which is a trustee of the trust may treat the trust as an exempt recipient without requiring a certificate.

(iii) *Exempt recipient no longer exempt.* Any person who ceases to be an exempt recipient, shall no later than 10 days after such cessation, notify the payor when it ceases to be an exempt recipient unless it reasonably appears that the person formerly qualifying as an exempt recipient will not thereafter receive a reportable payment from the payor. If a payor treats a person as an exempt recipient by requiring the exempt recipient to file a certificate claiming exempt status, that person shall revoke the certificate as provided in the preceding sentence. A person notifies a payor that it no longer qualifies as an exempt recipient by delivering to the payor a written statement to that effect. If the exempt recipient terminates its relationship with the payor, the exempt recipient is not required to notify the payor. If, however, the person who formerly qualified as an exempt recipient later reinstates the relationship with the payor, the person must notify the payor that it no longer qualifies as an exempt recipient in case the payor relies upon the previous treatment.

(iv) *Examples.* The application of the provisions of paragraph (c)(1) of this section may be illustrated by the following examples:

Example (1). In 1980, Corporation Y issued 10-year debentures with 9 percent interest coupons payable semiannually on June 30 and December 31. Individual F presents a coupon for payment at Bank M on the interest payment date. Bank M transmits the coupon to Bank N, which in turn presents the coupon to Corporation Y for payment. Bank M is required to make an information return with respect to the payment to Individual F under §1.6049-4(a)(2)(iii). Bank N is not required to make an information return with respect to the payment to Bank N because Banks M and N are exempt recipients described in §1.6049-4(c)(1)(ii)(M).

Example (2). Broker E acquires a bond issued in 1980 by the United States Treasury through the Bureau of Public Debt. Broker E sells interests in the bond to the public after December 31, 1982. A purchaser may acquire an interest in any interest payment falling due under the bond or an interest in the principal of the bond. The bond is held by Custodian H for the benefit of the persons acquiring these interests. Custodian H is known generally in the investment community as a nominee. On receipt of interest and principal payments under the bond, Custodian H transfers the amount received to the person whose ownership interest corresponds to the component giving rise to the payment. Under either section 1232B or section 1286, each bond component is treated as a bond issued with original issue discount equal to the excess of the stated redemption price at maturity over the purchase price of the bond component. Accordingly, H is required to make an information return setting forth the information required in §1.6049-4(b)(2) with respect to each holder of an interest in the bond. The Bureau of Public Debt is required to make an information return since it made payment to Custodian H who is not an exempt recipient.

* * * * *

(d) *Special rules*—***

(7) *Magnetic media requirement.**** For the requirement to submit the information required by Form 1099 on magnetic media for payments after December 31, 1983, see section 6011(e) and §301.6011-2 of this chapter (Regulations on Procedure and Administration).

* * * * *

(f) *Definitions.* ***

(4) *Middleman*—(i) *In general.* *** A person shall be considered to be a middleman as to any portion of an interest payment made to such person which portion is actually owned by another person, whether or not the other person's name is also shown on the information return filed with respect to such interest payment, except that a husband or wife will not be considered as acting in the capacity of a middleman with respect to his or her spouse. A person who, from within the United States, forwards an interest coupon or discount obligation on behalf of a payee for presentation, collection or payment

outside the United States is also a middleman for purposes of this section (but the transfer, although subject to information reporting under this section, does not make the payment subject to backup withholding under section 3406).

(ii) *Example.* *** Broker B is required to make an information return showing the amount of original issue discount treated as paid to A during 1984 under §1.6049-5(k).

* * * *

Par. 17. Section 1.6049-5 is amended by—

1. Removing the phrase "section 3451" each place it appears in paragraph (a) and adding the phrase "section 3406";
2. Removing the last sentence of paragraph (a)(6);
3. Revising paragraph (b);
4. Redesignating paragraph (c) as paragraph (k) and revising the last sentence in paragraph (k); and
5. Adding new paragraphs (c) through (j) and (l).

These revised and added provisions read as follows:

§1.6049-5 Interest and original issue discount subject to reporting after December 31, 1982.

* * * * *

(b) *Interest excluded from reporting requirement.* The term "interest" does not include—

(1) Interest on any obligation issued by a natural person or defined in §1.6049-4(f)(2) irrespective of whether such interest is collected on behalf of the holder of the obligation by a middleman.

(2) Interest on any obligation if such interest is exempt from taxation under section 103(a), relating to certain governmental obligations, or interest which is exempt from taxation under any other provision of law without regard to the identity of the holder. The holder of a tax exempt obligation must provide written certification to the payor (other than the issuer of the obligation) that the obligation is exempt from taxation. A statement that interest coupons are tax exempt on the envelope or "shell" commonly used by financial institutions to process such coupons, signed by the payee, will be sufficient for this purpose if the envelope is properly completed (i.e., shows the name, address, and taxpayer identification number of the payee). A payor may rely on such written certification in treating such interest as tax exempt for purposes of section 6049. See §1.6049-4(d)(8) with respect to the requirement that the issuer of a taxable obligation shall make an information return if such issuer receives an envelope which improperly claims that the interest coupons contained therein are tax exempt.

(3) Interest on amounts held in escrow to guarantee performance on a contract or to provide security. However, interest on amounts held in escrow with a person described in paragraph (a)(2) or (3) of this section is interest subject to reporting under section 6049.

(4) Interest that a governmental unit pays with respect to tax refunds.

(5) Interest on deposits for security, such as deposits posted with a public utility company. However, interest on deposits posted for security with a person described in paragraph (a)(2) or (3) of this section is interest subject to reporting under section 6049.

(6) For obligations issued in taxable years beginning on or before December 31, 1983, any amount on which the person making the payment is required to deduct and withhold a tax under section 1451 (relating to tax free convenant bonds), or would be so required but for section 1451(d) (relating to benefit of personal exemptions).

(7) Any amount in paragraph (c) of this section (relating to amounts paid to a person who is not a United States person).

(8) Any amount described in paragraph (d) of this section (relating to amounts paid with respect to obligation of, or deposits with, certain persons who are not United States persons, that is income from sources outside the United States, or that is paid by certain payee agents).

(9) Any amount paid by an international organization described in §1.6049-4(c)(1)(ii)(G) (or its paying, transfer, or other agent that is not also a payee's agent) with respect to an obligation of which the international organization is the issuer, provided the international organization is an organization of which the United States is a member and which enjoys immunity with respect to the inviolability of its archives pursuant to an international agreement having full force and effect in the United States.

(c) *Amount paid to persons who are not United States persons.* An amount is described in this paragraph (c) and is thus considered to be an amount paid to a person who is not a United States person and an amount not subject to information reporting under section 6049 if subparagraph (1), (2), (3), (4), (5), or (6), of this paragraph (c) applies. For the rule regarding reporting of an amount paid to joint payees where any of the payees is other than a person who is not a United States person, see §1.6049-6(1).

(1) This subparagraph (1) applies if, the payor or middleman receives from the payee the penalties of perjury statement described in paragraph (g) of this section in accordance with the provisions of that paragraph or the amount is described in section 871(i)(2)(A) and paragraph (e)(2)(i) or (ii). However, this paragraph (1) does not apply if the payor or middleman has actual knowledge that the payee is a United States person or the amount is described in paragraph (e)(2) (other than paragraph (e)(2)(i) or (ii)).

(2) This subparagraph (2) applies if the amount paid is subject to withholding of tax under subchapter A of chapter 3 of the Code by the person paying such amount. A payor or middleman may treat an amount as subject to withholding under subchapter A of chapter 3 of the Code for purposes of this subparagraph (2) if such person, or another payor or middleman from whom such person collects the amount, in fact withholds tax on such amount under subchapter A of chapter 3 in accordance with the provisions of chapter 3.

(3) This subparagraph (3) applies if the amount would be subject to withholding of tax under subchapter A of chapter 3 of the Code by the person paying such amount but for the fact that it is exempt from withholding of tax under section 1441(a) or 1442(a) by reason of the provisions of a tax treaty. Unless it has actual knowledge that

the payee of an amount is a United States person, a payor or middleman may treat such amount as an amount described in this subparagraph (3) if with respect to such amount the payor or middleman receives from the payee a Form 1001 in accordance with §1.1441-6(b) or (c) and completed under penalties of perjury.

(4) This subparagraph (4) applies if the amount would be subject to withholding of tax under subchapter A of chapter 3 of the Code by the person paying such amount but for the fact that it is exempt from withholding of tax under section 1441(a) or 1442(a) by reason of the application of section 1441(c) and paragraph (a) or (f) of §1.1441-4. Unless it has actual knowledge that the payee of an amount is a United States person, a payor or middleman may treat such amount as an amount described in this subparagraph (4) if with respect to such amount it has received a Form 4224 from the payee in accordance with §1.1441-4(a) and completed under penalties of perjury or has on file with respect to such amount a notice described in §1.1441-4(f)(2)(ii).

(5) This subparagraph (5) applies if the amount would be subject to withholding of tax under subchapter A of chapter 3 of the Code by the person paying such amount but for the fact that the amount is original issue discount. Unless it has actual knowledge that the payee of an amount is a United States person, a payor or middleman may treat such an amount as an amount described in this subparagraph (5) if—

(i) With respect to any amount that is or may be paid to the payee during the calendar year the payor or middleman has received the documentation described in subparagraph (3) or (4) of this paragraph (c) in accordance with the provisions of §1.1441-4 or §1.1441-6; or

(ii) Except as provided in paragraph (f) of this section, the amount is paid by the issuer or its agent outside the United States with respect to an obligation that—

(A) Has a face amount of not less than $500,000;

(B) Has a maturity (at issue) of 183 days or less;

(C) Satisfies the requirements of section 163(f)(2)(B)(i) and (ii)(I) and the regulations thereunder (as if it would otherwise be a registration-required obligation within the meaning of section 163(f)(2)(A));

(D) If in registered form, is registered in the name of an exempt recipient described in §1.6049-4(c)(1)(ii); and

(E) Has on its face the following statement (or a similar statement having the same effect): "By accepting this obligation, the holder represents and warrants that it is not a United States person (other than an exempt recipient described in section 6049(b)(4) of the Internal Revenue Code and regulations thereunder) and that it is not acting for or on behalf of a United States person (other than an exempt recipient described in section 6049(b)(4) of the Internal Revenue code and the regulations thereunder)".

Unless it has actual knowledge to the contrary, a middleman may treat an obligation as satisfying the requirements of section 163(f)(2)(B)(i) and (ii)(I) and the regulations thereunder if the obligation contains the statement in the preceding sentence.

(6) This subparagraph (6) applies, unless a payor or middleman has actual knowledge that the payee is a United States person or unless paragraph (f) of this section applies, if the amount is portfolio interest described in section 871(h)(2)(A) or (B) or 881(c)(2)(A) or (B) and the regulations thereunder that is exempt from withholding of tax under sections 1441(a) or 1442(a) by reason of the application of section 1441(c)(9) and the amount is paid outside the United States.

(d) *Amounts from sources outside the United States and amounts paid with respect to obligations of certain foreign persons*—(1) *In general*. An amount is described in paragraph (d) of this section and thus is not subject to information reporting under section 6049 if paragraph (d)(2) or (d)(3) of this section applies to such amount.

(2) *Amounts from sources outside the United States paid inside the United States*. This paragraph (d)(2) applies, unless a payor or middleman has actual knowledge that a payee of an amounts is a United States person, if an amount is from sources outside the United States within the meaning of section 862(a)(1) that is paid inside the United States and the payor or middleman receives from the payee the penalties of perjury statement described in paragraph (g) of this section or, with respect to any amount that is or may be paid to the payee during the calendar year, the payor or middleman has received the documentation described in paragraph (c)(3) or (4) of this section in accordance with the provisions of §1.1441-4 or §1.1441-6.

(3) *Certain amounts paid outside the United States*. This paragraph (d)(3) applies, unless paragraph (e) or (f) of this section applies, if an amount is paid outside the United States and the amount is described in paragraph (d)(3)(i), (ii), or (iii).

(i) An amount is described in this subdivision (i) if it is paid or collected with respect to an obligation of, or deposit with, or an amount an issuer or other obligor that is—

(A) A foreign government or international organization or any agency or instrumentality thereof;

(B) A foreign central bank of issue;

(C) A foreign corporation not engaged in a trade or business in the United States within the calendar year of the payment; or

(D) A partnership that is not engaged in a trade or business in the United States within the calendar year of the payment and that is composed in whole of nonresident alien individuals or persons described in paragraph (d)(3)(i)(A), (B), or (C) of this section.

(ii) An amount is described in this subdivision (ii) if it is income not otherwise described in subdivision (i) of this paragraph (d)(3) that is from sources outside the United States within the meaning of section 862(a)(1).

(iii) An amount is described in this subdivision (iii) if it is paid by a middleman (other than a United States person or a United States-related person as described in §1.6049-5(f)(2)) that, as a custodian or nominee or other agent of a payee (and not as the agent of the issuer), collects the amount for or on behalf of the payee.

(4) *Determination by a paying agent or middleman that an amount is described in paragraph (d)(3) of this section.* The provisions of this paragraph (d)(4) apply with respect to determinations made by paying agents and middlemen as to whether an amount is paid with respect to an obligation or deposit of an entity described in paragraph (d)(3)(i) of this section and as to whether an amount is income from sources outside the United States for purposes of paragraph (d)(3)(ii).

(i) *With respect to a foreign government, an international organization, or a foreign central bank of issue.* Absent actual knowledge to the contrary, a paying agent or middleman may treat an entity as a foreign government, an international organization, or a foreign central bank of issue if the paying agent or middleman could treat such entity under §1.6049-4(c)(1)(ii) as an exempt recipient without the receipt of a Form W-9 or an acceptable substitute.

(ii) *With respect to a foreign corporation.* Absent actual knowledge to the contrary, a middleman generally may treat a corporation as a foreign corporation if its name reasonably so indicates and, if so, may treat it as a foreign corporation described in paragraph (d)(3)(i)(C) of this section. A payment agent of, or middleman having a contractual relationship with, the corporation with respect to the paying of an amount may treat it as a corporation described in paragraph (d)(3)(i)(C) of this section unless the paying agent or middleman has reason to believe to the contrary. Absent actual knowledge to the contrary, a paying agent will not be considered to have reason to believe that a corporation is not described in paragraph (d)(3)(i)(C) of this section if the paying agent receives a statement signed under penalties of perjury from a corporate officer who would be authorized by section 6062 to sign returns on behalf of the corporation either that the corporation is not, or does not expect during the calendar year of payment to be, engaged in trade or business in the United States. However, failure to obtain this statement will not in itself be considered evidence that the paying agent has reason to believe that the corporation is not described in paragraph (d)(3)(i)(C) of this section.

(iii) *With respect to domestic corporations.* Absent actual knowledge to the contrary, a middleman generally may treat a domestic corporation as a corporation the interest payments of which would not be subject to withholding under subchapter A of chapter 3 of the Code if such payments were made to a person who is not a United States person if an annual report, offering circular, or other standard source of financial information published by the corporation reasonably so indicates. However, a paying agent of, or a middleman having a contractual relationship with, a domestic corporation with respect to the payment or collection of an amount may, absent actual knowledge to the contrary, treat a domestic corporation as such a corporation only if a corporate officer authorized by section 6062 to sign returns on behalf of the corporation provides the paying agent or middleman with a statement signed by the officer under penalties of perjury that interest paid by such corporation would be income from sources outside the United States.

(iv) *With respect to partnership.* A paying agent or middleman may, absent actual knowledge to the contrary, treat a partnership as a partnership that is not engaged in a trade or business in the United States during the calendar year of payment and that is composed in whole of nonresident alien individuals or persons described in paragraph (d)(3)(i)(A), (B), or (C) of this section if it receives a statement, signed under penalties of perjury, by any partner of the partnership authorized by section 6063 to sign returns on behalf of the partnership, that the partnership is not, and is not expected during the calendar year of the payment to be, engaged in a trade or business in the United States and that all of its partners are, and are expected during the during the calendar year of payment to be, nonresident alien individuals or persons described in paragraph (d)(3)(i)(A), (B), or (C) of this section.

(v) *When to receive statement and retention.* A paying agent or middleman must receive the statement described in paragraph (d)(4) of this section in the calendar year in which a payment is made or collected or in either of the 2 preceding calendar years. The paying agent or middleman may, however, require such a statement from the corporation or partnership each time it makes a payment for the corporation or partnership. The paying agent or middleman shall retain the statement for at least 4 years following the end of the last calendar year during which an amount to which the statement relates is paid or collected. If after providing such statement the status of the corporation or partnership changes from that reflected in the statement, the corporation or partnership shall notify the paying agent or middleman within 30 days of such change in status.

(e) *Exception for certain amounts.* Notwithstanding paragraph (c) or (d) of this section, an amount will be considered to be interest for purposes of reporting under section 6049 and this section if the payment is either—

(1) Made to, or collected on behalf of, a United States person (as determined in accordance with paragraph (e)(3) of this section) by either a United States person or a United States-related person under §1.6049-5(f)(2) that is in the commercial banking business with respect to an account or deposit maintained at an office of such person outside the United States (other than a deposit evidenced either by a foreign-targeted registered obligation as defined in §1.6049-5(j)(4) or by a bearer obligation that such person has issued in accordance with the procedures of §1.163-1(c)(2)(i)(B), provided that such person does not act in the capacity of a custodian, nominee or other agent of the payee with respect to the obligation); or

(2) Made to a nonresident alien individual who is a resident of Canada and the amount is described in section 871(i)(2)(A) with

respect to a deposit maintained at an office within the United States. Amounts described in this paragraph (e)(2) are exempt from backup withholding under section 3406. However, this paragraph (e)(2) shall not apply to either—

(i) Except as provided in paragraph (f) of this section, an amount described in section 871(i)(2)(A) that is paid by the issuer or its agent outside the United States with respect to an obligation that—

(A) Is not in registered form (within the meaning of section 163(f) and the regulations thereunder);

(B) Is described in section 163(f)(2)(B); and

(C) Is part of a larger single public offering of securities; or

(ii) Except as provided in paragraph (f) of this section, an amount described in section 871(i)(2)(A) that is paid by the issuer or its agent outside the United States with respect to an obligation that—

(A) Has a principal amount of not less than $500,000;

(B) Satisfies the requirements of section 163(f)(2)(B)(i) and (ii)(I) and the regulations thereunder (as if it were a registration-required obligation within the meaning of section 163(f)(2)(A));

(C) If in registered form, is registered in the name of an exempt recipient described in §1.6049-4(c)(1)(ii); and

(D) Has on its face, and on any detachable coupons the following statement (or a similar statement having the same effect): "By accepting this obligation or coupon, the holder represents and warrants that it is not a United States person (other than an exempt recipient described in the regulations under section 6049(b)(4) of the Internal Revenue Code and the regulations thereunder) and that it is not acting for or on behalf of a United States person (other than an exempt recipient described in the regulations under section 6049(b)(4) of the Internal Revenue Code and the regulations thereunder)".

For purposes of paragraph (e)(2)(i), unless it has actual knowledge to the contrary, a middleman may treat an obligation as if it is described in section 163(f)(2)(B) if the obligation or coupon therefrom, whichever is presented for payment, contains the statement described in section 163(f)(2)(B)(ii)(II) and the regulations thereunder. For purposes of paragraph (e)(2)(ii), unless it has actual knowledge to the contrary, a middleman may treat an obligation as satisfying the requirements of section 163(f)(2)(B)(i) and (ii)(I) and the regulations thereunder if the obligation or a coupon therefrom, whichever is presented for payment, contains the statement described in paragraph (e)(2)(ii).

(3) *United States person for purposes of paragraph (e)(1) of this section.* Paragraph (h) of this section applies in determining whether a person is a United States person for purposes of paragraph (e)(1) of this section.

(4) *Nonresident alien individual for purposes of paragraph (e)(2) of this section.* Paragraph (g) of this section applies in determining whether a person is a nonresident alien individual for purposes of paragraph (e)(2) of this section. The country contained in the address required to be provided under paragraph (g) is considered the country of residence of a nonresident alien individual for purposes of paragraph (e)(2).

(f) *Payments by middleman outside the United States*—(1) Notwithstanding the provisions of paragraph (c)(5)(ii) and (6), paragraph (d)(3), and paragraph (e)(2)(i) and (ii) of this section, an amount paid outside the United States by a middleman that is either a United States person or a United States-related person (as described in subparagraph (f)(2) and that, as a custodian or nominee or other agent of a payee, collects the amount for or on behalf of the payee shall be treated as interest for purposes of section 6049 and this section unless the middleman may treat the payee as a person who is not a United States person in accordance with the provisions of paragraph (h) of this section. For purposes of this paragraph (f), a middleman is considered to collect an amount as an agent of a payee if the payee has an account with the middleman's office that makes the payment. Also, this paragraph (f) applies to a middleman that is also a paying, transfer, or other agent of the payor.

(2) A United States-related person is either a controlled foreign corporation within the meaning of section 957(a) or a foreign person 50 percent or more of the gross income of which, from all sources for the three-year period ending with the close of its taxable year preceding the collection or payment (or such part of such period as the person has been in existence), was effectively connected with the conduct of a trade or business within the United States.

(g) *Penalties of perjury statement*—(1) *In general.* The statement described in this paragraph is a statement, signed by the payee under penalties of perjury, certifying that the payee is not a United States person, or in the case that the payee is an individual, that he is neither a citizen nor a resident of the United States. The statement must also contain the name of the payee, the address of the payee, and the taxpayer identification number (if any) of the payee. The address provided for an individual shall be that of his permanent residence; the address provided for a partnership or corporation shall be the address of its principal office; and the address provided for a trust or estate shall be the address of the permanent residence or principal office of any fiduciary of the trust or estate. The statement may be made, at the option of the payor or middleman, on a Form W-8 or on a substitute form prepared by the payor or middleman that is substantially similar to Form W-8.

(2) *Who may sign the statement.* The statement may be signed by any person who is authorized to sign a declaration under penalties of perjury on behalf of the payee as described in section 6061 and the regulations thereunder.

(3) *When statement must be received and retention.* Except as otherwise provided in paragraph (g)(5) of this section, the statement must be received by the payor or middleman in the calendar year in which the payment is made or collected or in either of the preceding 2 calen-

dar years. The payor or middleman, however, may require the statement from the payee each time it makes a payment to, or collects an amount on behalf of, the payee. The payor or middleman shall retain the statement for at least 4 years following the end of the last calendar year during which the amount to which the statement relates is paid or collected. If the person providing the statement becomes a United States citizen or resident during the period to which the statement relates, such person shall notify the payor in writing within 30 days of the change in status.

(4) *Joint payees.* If interest is paid with respect to a joint account with a payor or middleman, the payor or middleman must receive the statement from each joint owner. If a joint owner is a United States person, see paragraph (l) of this section.

(5) *Special rule prior to January 1, 1985.* With respect to a pre-1984 account (as described in the regulations under section 3406) or a brokerage relationship that is not a post-1983 brokerage account (as described in the regulations under section 3406) the payor or middleman is not required to obtain the statement before January 1, 1985, if—

(i) The payor or middleman sent an additional separate mailing to the payor on or before December 31, 1983, requesting the statement (or the payor or middleman sent a nonseparate mailing on or before December 31, 1983, requesting the statement and sent a separate mailing requesting the statement on or before March 31, 1984),

(ii) The payor or middleman sent a mailing (which may be a nonseparate mailing during the calendar year 1984) requesting the statement, and

(iii) The payor or middleman has documentary evidence in its records that the customer is an exempt foreign person in accordance with A-34 of §35a.9999-3 published at 49 FR 33236 on August 22, 1984 [1984-2 C.B. 325]. [In the final regulations, the text of the rule in A-34 will be inserted in this paragraph. The mailings described in paragraph (g)(5)(i) and (ii) of this section must have been sent by first-class mail, or by airmail if sent to a foreign address, and must have contained a notice describing the penalties of perjury statement described in paragraph (g)(1) of this section and advising the payee that backup withholding under section 3406 may commence if the statement is not provided. The payor or middleman must also have provided a reply envelope and a form on which the payee might make the statement described in paragraph (g)(1) of this section. A separate mailing, for purposes of this paragraph (g)(5), is a mailing that contains only the information described in this paragraph and, at the option of the payor or middleman, information relating to the solicitation of a taxpayer identification number. With respect to mail-hold accounts and accounts with respect to which the last-known address of the payee is incorrect, the payor middleman will be considered to have satisfied the requirements of paragraph (g)(5)(i) and (ii) of this section if the payor or middleman handled the mailings in the same manner that it handled other correspondence with the payee. A payor or middleman may also satisfy the requirements of this paragraph (g)(5)(i) and (ii) if the mailings were delivered to the payee by personal delivery or intra-office mail, provided they were delivered by the same method used generally by the payor or middleman in delivering account information and other correspondence to the payee.

(6) *Exception.* A payor or middleman is not required to obtain the statement described in paragraph (g)(1) of this section from a payee if the payee has provided the payor or middleman with Form W-9 (or acceptable substitute) form) or if the payor or middleman may treat the payee as an exempt recipient under §1.6049-4(c)(1)(ii) without receiving a Form W-9 (or acceptable substitute form) from the payee.

(h) *Information indicated that a payee is a foreign person.* A payor or middleman may treat a payee as a person who is not a United States person in accordance with paragraph (h) of this section if the payor has documentary evidence in its records that the payee is not a United States person (provided that the payor does not have actual knowledge that the evidence is false). A payor or middleman has documentary evidence in its records that the customer is not a United States person if (1) the payor or middleman obtains and has in its records the statement described in paragraph (g) of this section, Form 1001 completed under penalties of perjury, or Form 4224 completed under penalties of perjury, or (2) the payor or middleman has been provided with documentary evidence (such as a passport, identity credential, or other similar evidence of citizenship and residence) on the basis of which a reasonable person would conclude that the customer is not a United States person, and the employee of the payor or middleman who has been provided with such evidence signs a separate written statement as part of the records of the account which states that such evidence has been provided and specifies the nature and details of the evidence. The mere fact, however, that the payee has provided an address outside the United States is insufficient evidence to establish for this purpose that the payee is not a United States person.

(i) *Examples.* The application of the provisions of paragraphs (c), (d), (e) and (f) of this section may be illustrated by the following examples.

Example (1). DB, a domestic corporation engaged in a commercial banking business, pays interest on a deposit with an account maintained by A, a non-resident alien individual, at a branch of DB in the United States. A has signed and provided DB with a Form W-8 during the current calendar year. DB is required to make an information return by reason of the application of paragraph (e)(2) of this section with respect to interest paid to A. However, the payment is not subject to backup withholding under section 3406.

Example (2). B, an individual, holds a bearer certificate of deposit issued in 1984 by SL, a federally-chartered savings and loan institution, as part of a larger single public offering of securities. The certificate of deposit has a maturity at issue of one year. It was issued by SL under arrangements satisfying the provisions of section 163(f)(2)(B)(i) and the regulations thereunder and contains on its face and on each detachable interest coupon the statement described in section 163(f)(2)(B)(ii)(II) and the regulations thereunder. Interest is payable on the obligation only by presentation of a coupon at a foreign office of DC, a domestic corporation that is the designated paying agent of SL with respect to the obligation. B does not have an account with the office of DC that pays the interest. DC does not have actual knowledge that B is a United States person. B presents a coupon for payment to DC at its foreign office, and DC pays the obligation in cash. Because the coupon contains the statement described in section 163(f)(2)(B)(ii)(II), DC may treat the obligation as an obligation described in paragraph (e)(2)(ii) of this section. Therefore, the payment by DC to B is considered not to be interest for purposes of section 6049 under paragraph (e)(2)(i) of this section, and DC is not required to make an information return with respect to the payment.

Example (3). The facts are the same as in Example (2) except that the certificate of deposit is held on B's behalf in a custodial account by FC, a wholly-owned foreign country X subsidiary of a domestic financial institution. FC presents the coupon for payment to the foreign office of DC. By reason of the application of paragraph (f) of this section, FC is required to treat the amount collected on behalf of A as interest subject to information reporting under section 6049 unless FC can establish under paragraph (h) of this section that B is not a United States person.

Example (4). FC is a foreign corporation that is not engaged in a trade or business in the United States during the current calendar year. D, an individual who is a resident and citizen of the United States, holds a registered obligation issued by FC in a public offering. Interest is paid on the obligation within the United States by DC, the designated paying agent of FC. D does not have an account with DC. Although FC is a corporation described in paragraph (d)(3)(i) of this section, the interest paid by DC to D is considered to be interest for purposes of information reporting under section 6049 since it is paid in the United States.

Example (5). The facts are the same as in Example (4) except that D is a nonresident alien individual who has signed and provided DC with a Form W-8 in accordance with paragraph (g) of this section. By reason of paragraph (c)(1) or (d)(2) of this section, the payment of interest by DC to D is not considered to be a payment of interest for purposes of information reporting under section 6049. Therefore, DC is not required to make an information return under section 6049.

Example (6). The facts are the same as in Example (4) except that DC pays interest on the obligation at its branch outside the United States. The payment of interest by DC to D is not considered to be payment of interest for purposes of information reporting under section 6049 because the amount is described in paragraph (d)(3)(i). Therefore, DC is not required to make an information return under section 6049.

Example (7). The facts are the same as in Example (6) except that the obligation of FC is held in a custodial account for D by FB, a foreign branch of a domestic financial institution. By reason of paragraph (f) of this section, FB is considered to have collected interest on behalf of D for purposes of section 6049. Therefore, FB is required to make an information return unless FB may treat D as a person who is not a United States person in accordance with the provisions of paragraph (h) of this section.

Example (8). The facts are the same as in Example (7) except that the FC obligation is held for D by NC, in a custodial account at NC's foreign branch. NC is a foreign corporation that is not a United States-related person as described in paragraph (f)(2) on the New York Stock Exchange. Under paragraph (d)(3)(iii), the payment by NC to D is not considered to be a payment of interest for purposes of section 6049. Therefore, NC is not required to make an information return under section 6049 with respect to the payment.

Example (9). FB, a foreign country X branch of a domestic corporation, engages in the commercial banking business in foreign country X. FB pays interest to E, a United States citizen residing in foreign country X, on a deposit in an account maintained by E with FB. Although the records of FB show a foreign country X address of residence for E, FB does not have sufficient information in its files to establish under paragraph (h) of this section that E is not a United States person. The payment by FB to E is considered to be a payment of interest for purposes of section 6049 under paragraph (e)(1) of this section. Therefore, FB is required to make an information return under section 6049.

Example (10). The facts are the same as in example (9) except that FB is a wholly owned foreign subsidiary of a domestic corporation. The payment by FB to E is considered to be a payment of interest for purposes of section 6049 under paragraph (e)(1) of this section. Therefore, FB is required to make an information return under section 6049.

(j) *Determination of whether amounts are considered paid outside the United States*—(1) *In general.* For purposes of section 6049 and this section, an amount is considered to be paid by a payor or middleman outside the United States if the payor or middleman completes the acts necessary to effect payment outside the United States. A payment shall not be considered to be made within the United States for purposes of section 6049 by reason of the fact that it is made on a draft drawn on a United States bank account or by a wire or other electronic transfer from a United States account. However, without regard to the location of the account from which the amount is drawn, an amount that is described in subdivision (i) or (ii) of this paragraph (j)(1) and paid by transfer to an account maintained by the payee in the United States or by mail to a United States address is considered to be paid within the United States.

(i) The amount is paid by an issuer or the paying agent of the issuer and the obligation is either—

(A) Issued by a United States person, or by a United States-related person under §1.6049-5(f)(2);

(B) Registered under the Securities Act of 1933; or

(C) Listed on an exchange that is registered as a national securities exchange in the United States or included in an interdealer quotation system in the United States.

(ii) The amount is paid by a middleman that, as a custodian, nominee, or other agent of the payee, collects the amount for or on behalf of the payee if the middleman is a United States person or United States-related person under §1.6049-5(f)(2).

(2) *Amounts paid with respect to deposits or account with banks and other financial institutions.* Notwithstanding paragraph (j)(1) of this section, an amount paid by a bank or other financial institution with respect to a deposit or with respect to an account with the institution is considered to be paid at the branch or office at which the amount is credited unless the amount is collected by the financial institution as the agent of the payee. However, an amount will not be considered to be paid at the branch or office where the amount is considered to be credited unless—

(i) The branch or office is a permanent place of business that is regularly maintained, occupied, and used to carry on a banking or similar financial business;

(ii) The business is conducted by at least one employee of the branch or office who is regularly in attendance at such place of business during normal business hours; and

(iii) The branch or office receives deposits and engages in one or more of the other activities described in §1.864-4(c)(5)(i).

In addition, an amount paid by a bank or other financial institution with respect to a deposit or an account with the institution is not considered to be paid at a branch or office outside the United States if the customer has transmitted instructions to an agent, branch, or office of the institution from inside the United States by mail, telephone, electronic transmission or otherwise concerning the deposit or account (unless the transmission from the United States has taken place in isolated and infrequent circumstances).

(3) *Coupon bonds and discount obligations in bearer form.* Notwithstanding paragraph (j)(1) of this section, an amount paid with respect to a bond with coupons attached (including a certificate of deposit with detachable interest coupons) or a discount obligation that is not in registered form (within the meaning of section 163(f) and the regulations thereunder) is considered to be paid where the coupon or the discount obligation is presented to the payor or its paying agent for payment. However, without regard to where the coupon or discount obligation is presented for payment, an amount paid with respect to either a bond with coupons attached or a discount obligation by transfer to an account maintained by the payee in the United States or by mail to a United States if the payment is described in subdivision (i) and (ii) of this paragraph (j)(3).

(i) The amount is paid by an issuer or the paying agent of the issuer and the obligation is either—

(A) Issued by a United States person or a United States-related person under §1.6049-5(f)(2);

(B) Registered under the Securities Act of 1933; or

(C) Listed on an exchange that is registered as a national securities exchange in the United States or included in a interdealer quotation system in the United States.

(ii) The amount is paid by a middleman that, as a custodian, nominee, or other agent of payee, collects the amount for or on behalf of the payee if the middleman is a United States person or a United States-related person under §1.6049-5(f)(2).

(4) *Foreign-targeted registered obligations.* Notwithholding paragraph (j)(1) of this section, where the payor is the issuer or the issuer's agent, an amount is considered paid outside the United States with respect to a foreign-targeted registered obligation if the conditions of either subdivision (i) or (ii) of this paragraph (j)(4) are met. (A foreign-targeted registered obligation is an obligation that is issued in registered form under section 163(f) and the regulations thereunder and that is described in Q & A's 12 and 13 of §35a.9999-5. These questions and answers refer to obligations with respect to which interest is paid to a registered owner that is a financial institution at an address outside the United States if the obligation is targeted to foreign markets.)

(i) The amount is paid by transfer to an account maintained by the registered owner outside the United States or by mail to an address of the registered owner outside the United States.

(ii) The amount is paid by credit to an international account.

For purposes of subdivision (ii) of this paragraph (j)(4), an international account is the book-entry account of a financial institution (within the meaning of section 871(h)(4)(B)) or of an international financial organization with the Federal Reserve Bank of New York for which the Federal Reserve Bank of New York maintains records that specifically identify an international financial organization or a financial institution (within the meaning of section 871(h)(4)(B)) that is either a non-United States person or a foreign branch of a United States person as registered owner. An international financial organization is a central bank or monetary authority of a foreign government or a public international organization of which the United States is a member that is characterized as a foreign corporation for United States federal income tax purposes to the extent that such central bank, authority, or organization holds obligations solely for its own account and is exempt from United States federal income tax section 892 or 895 of the Internal Revenue Code.

(5) *Examples.* The application of the provisions of paragraph (j) of this section may be illustrated by the following examples:

Examples (1). FC is a foreign corporation that is not a United States-related person under §1.6049-5(f)(2). A holds bonds that are not in registered form under section 163(f) and the regulations thereunder, that were issued by FC in a public offering outside the United States, that are not registered under the Securities Act of 1933, and that are neither listed on an exchange that is registered as a national securities exchange in the United States nor included in an interdealer quotation system. DC, a domestic corporation that is engaged in a commercial banking business, is the designated fiscal agent for FC. FB, a foreign branch of DC, is the designated paying agent with respect to the bonds issued by FC. A does not have an account with FB. A presents a coupon from a FC bond for payment to FB at its office outside the United States. FB pays A with a check drawn against a bank account maintained in the United States. For purposes of section 6049, the place of payment of interest on the FC bond by FB to A is considered to be outside the United States under paragraph (j)(3) of this section.

Example (2). The facts are the same as in example (1) except that A presents the coupon to FB at its office outside the United States with instructions to transfer funds in payment to a bank account maintained by A in the United States. FB transfers the funds in accordance with A's instructions. Even though the amount is credited to an account in the United States, the place of payment of interest on the FC bonds is considered to be outside the United States under paragraph (j)(3) of this section since the coupon is presented for payment outside the United States, since FC is a foreign person that is not a United States-related person under §1.6049-5(f)(2), since FB is not acting as A's agent, and since the obligation is not registered under the Securities Act of 1933, listed on a securities exchange that is registered as a national securities exchange in the United States, or included in an interdealer quotation system.

Example (3). FC is a foreign corporation that is not a United States-related person. B, a United States citizen, holds a bond issued by FC in registered form under section 163(f) and the regulations thereunder and registered under the Securities Act of 1933. The bond is not a foreign-targeted registered oblignation as defined in paragraph (j)(3). DB, a United States branch of a foreign corporation engaged in the commercial banking business, is the registrar of the bonds issued by FC. DB supplies FC with a list of the holders of the FC bonds. Interest on the FC bonds is paid to B and other bondholders by checks prepared by FC at its principal office outside the United States, and B's check is mailed from there to his designated address in the United States. The bond is described in paragraph (j)(1)(i)(B). The place of payment to B by FC of the interest on the FC bonds is considered to be inside the United States under paragraph (j)(1) of this section.

Example (4). The facts are the same as in example (3) except that the checks are prepared and mailed in the United States by

DC, a domestic corporation engaged in the commercial banking business that is the designated paying agent with respect to the bonds issued by FC, and B's check is mailed to his designated address outside the United States. For purposes of section 6049, the place of payment of DC of the interest on the FC bonds is considered to be within the United States under paragraph (j)(1) of this section.

Example (5). Individual C deposits funds in account with FB, a foreign country X branch of domestic bank DB. FB maintains an office and employees in foreign country X, accepts deposits, and conducts one or more of the other activities listed in §1.864-4(c)(5)(i). The terms of C's deposit provide that it will be payable in six months with accrued interest. On the day that the interest is credited to C's account with FB, C telephones DB from inside the United States and asks DB to direct FB to transfer the funds in his account with FB to an account C maintains in the United States with DB. Transmissions from the United States concerning this account have taken place in isolated and infrequent circumstances. Under paragraph (j)(2) of this section, FB is considered to have paid the interest on C's deposit outside the United States. For the requirement to report on the interest payment, see §1.6049-5(e)(1).

Example (6). The facts are the same as in example (5) except that C has placed his deposit with FB for an indefinite period of time. Interest will be credited to C's account daily. C has instructed FB to wire the interest at 90-day intervals to C's account with DB within the United States. FB is considered to have paid the interest credited to A's account outside the United States under paragraph (j)(2) of this section. For the requirement to report on the interest payment, see §1.6049-5(e)(1).

Example (7). DC, a domestic corporation engaged in the commercial banking business, maintains a branch in foreign country X. The branch has an office and employees in foreign country X, accepts deposits, and engages in one or more of the other activities listed in §1.864-4(c)(5)(i). D, a United States citizen, purchases a certificate of deposit issued in 1980 by the foreign country X branch. The certificate of deposit has a maturity of 20 years and has detachable interest coupons payable at six-month intervals. D presents more of the coupons at the United States office of DC and receives payment in cash. Because the coupon is presented to DC for payment with the United States, DC is considered to have made the payment within the United States under paragraph (j)(3) of this section.

Example (8). FB is recognized by both foreign country X and by the Federal Reserve Bank as a foreign country X branch of DC, a domestic corporation engaged in the commercial banking business. A local foreign country X bank serves as FB's resident agent in Country X. FB maintains no physical office or employees in foreign country X. All the records, accounts, and transactions of FB are handled at the United States office of DC. E deposits funds in an amount maintained with FB. Interest earned on the deposit is periodically credited to E's account with FB by employees of DC. For purposes of section 6049, the place of payment of the interest on E's deposit with FB is considered to be within the United States by reason of paragraphs (j)(1) and (j)(2) of this section.

Example (9). DC is a domestic corporation. A holds bonds that were issue by DC in registered form under section 163(f) and the regulations thereunder and that are foreign-targeted registered obligations as defined in paragraph (j)(4) of this section. DB, a commercial banking business, is the registrar of bonds issued by DC. Interest on the DB bonds is paid to A and other bondholders by check prepared by DB at its principal office inside the United States and mailed from there to A's address outside the United States. The check is drawn on a United States account maintained by DC with DB within the United States. The place of payment to A by DB of the interest on the DC bonds is considered to be outside the United States under paragraph (j)(4)(i) of this section.

(k) *Original issue discount treated as payment of interest.****

Original issue discount (including an obligation with a maturity of not more than 6 months from the date of original issue) described in §1.6049-5(c) or (d) is not interest subject to reporting under section 6049 unless it is described in §1.6049-5(e) or (f).

(l) *Joint Payees.* Unless each joint payee of an account or instrument is a person other than a United States person as determined under §1.6049-5(c), the exemption from reporting under that section does not apply. In order to avoid backup withholding on the payment, any one of the joint payees who has not established such payee's foreign status must provide a taxpayer identification number to the payor in the manner described in section 3406 and the regulations thereunder and the payor must show such payee as the first person on the account on the information return. See section 3406 and the regulations thereunder for backup withholding rules applicable to joint payees where not all such payees have established foreign status.

Par. 18. Section 1.6049-6 is amended by:

1. Removing the phrase "section 3451" each place it appears and adding in its place the phrase "section 3406",

2. Adding the following new sentence at the end of paragraph (a) to read as follows: "See paragraph (e) of this section for the requirement to furnish an official 1099 to the recipient and the manner of furnishing the statement for payments made after December 31, 1983"., and

3. Adding a new paragraph (e) to read as follows:

§1.6049-6 Statements to recipients of interest payments and holders of obligations as to which there is attributed original issue discount after December 31, 1983.

* * * *

(e) *Official statement to recipient for payments made after December 31, 1983*--(1) *In general.* Section 6049(c) and this section require any person who makes an information return under section 6049(a) and §1.6049-4 to furnish a statement to the person whose identifying number is required to be shown on the form. Except as provided in paragraph (e)(3) of this section, this requirement shall be met by furnishing to the recipient the official Form 1099 for payments of interest or original issue discount made after December 31, 1983.

(2) *Form of the statement.* The official Form 1099 shall be the form prescribed by the Internal Revenue Service for the respective calendar year.

(i) *Interest.* With respect to payments of interest (other than original issue discount) to any person during a calendar year, the statement shall show—

(A) The name, address and the taxpayer identification number of the recipient,

(B) The aggregate amount of payments made to (or received on behalf of) the person during the calendar year,

(C) The amount of the tax withheld under section 3406, if any,

(D) The name, address, and the taxpayer identification number of the person filing the form,

(E) A statement, in bold and conspicuous type, informing the recipient that the form contains important tax information that is being furnished to the Internal Revenue Service and that, if the recipient is required to file an income tax return, the recipient may be subject to a negligence penalty (as described in section 6653(g)) or other sanction in the event that the income is taxable on the recipient's tax return and the Internal Revenue

Service determines that the recipient has not included the income on the recipient's tax return, and

(F) Any other information required by the form.

(ii) *Original issue discount.* With respect to original issue discount includible in the gross income of a holder of an obligation during a calendar year, the statement shall show—

(A) The name, address, and the taxpayer identification number of the recipient,

(B) The aggregate amount of original issue discount includible in the gross income by (or on behalf of) such person for the calendar year with respect to the obligation (determined by applying the rules of paragraph (b)(2) of §1.6049-4),

(C) The amount of tax withheld under section 3406, if any,

(D) The name, address, and taxpayer identification number of the person filing the form,

(E) The amount, serial, or other identifying number of each obligation with respect to which a return is being made,

(F) A statement, in bold and conspicuous type, informing the recipient that the form contains important tax information that is being furnished to the Internal Revenue Service and that, if the recipient is required to file an income tax return, the recipient may be subject to a negligence penalty (as described in section 6653(g)) or other sanction in the event that the income is taxable on the recipient's tax return and the Internal Revenue Service determines that the recipient has not included the income on the recipient's tax return, and

(G) Any other information required by the form.

(3) *Substitute Forms 1099.* No reasonable facsimile (as described in paragraph (d) of this section) of the official Form 1099 will satisfy the requirement under this paragraph to furnish a statement to any recipient. A payor, however, may use a form that contains provisions that are substantially similar to those of the official Form 1099 if the payor complies with all applicable revenue procedures relating to substitute Forms 1099.

(4) *Aggregation of payments.* A payor may aggregate all payments of interest or original issue discount made to a recipient during a calendar year on one Form 1099.

(5) *Manner and time of providing the official statement to the recipient.* The official Form 1099 shall be provided to the recipient either in person or by first class mail at the time provided in paragraph (c). The Form 1099 shall be sent by first-class mail to the recipient at his last known address or personally delivered to the recipient.

(i) *Separate mailing requirement for forms to be filed after December 31, 1984, and on or before October 22, 1986.* With respect to a Form 1099 which is required to be filed after December 31, 1984 and on or before October 22, 1986 (without regard to extensions), a Form 1099 that is mailed to the recipient, generally must be furnished separately from any other mail (including the payment subject to reporting) that the payor mails to the recipient. The only items that may be mailed to the recipient with the Form 1099 are—

(A) Statements related to other Forms 1099, Forms 1098, and Forms 5498 (or the account balance on a Form 5498), and

(C) Any documents relating to a solicitation of the recipient's correct taxpayer identification number (Form W-9) or solicitation of a Form W-8 or a substitute form (as described in §1.6049-5(g)(1)).

If a payor does not either personally deliver the Form 1099 to the recipient or mail the Form 1099 in a separate first-class mailing to the recipient, the payor shall be considered to have failed to make the statement required under section 6049(c) and will be subject to the penalty under section 6678.

(ii) *Statement mailing requirement for forms to be filed after October 22, 1986.* [Reserved]

(6) *Special rule for amounts described in §1.6049-5(e)(2).* In the case of amounts described in §1.6049-5(e)(2), any persons who make a Form 1042S under section 6049(a) and §1.6049-4(b)(1), (b)(2), or (b)(3) shall furnish a statement to the recipient at the time and in the manner prescribed by §1.1461-2. The statement shall include the aggregate amounts of the payments, the amount of tax withheld under section 3406, if any, and the name, address, and taxpayer identification number of the person filing Form 1042S. The statement shall include a legend to the effect that information is being furnished to the United States Internal Revenue Service and may be furnished to the foreign country of legal residence. There is no requirement that the statement with respect of Form 1042S be personally delivered or mailed separately to the recipient.

Par. 19. Section 1.6050A-1 is amended by removing the phrase "Form 1099F" each place it appears and adding in its place the phrase "Form 1099".

PART 31—WITHHOLDING TAXES

Par. 20. The authority for Part 31 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. *** Section 31.3406(a)-3 also issued under 26 U.S.C. 3406(a), (b), (g) and (h), and sec. 6109.

Par. 21. Immediately after §31.3404-1, §31.3406(a)-1 and §31.3406(a)-2 are added and reserved and §31.3406(a)-3 is added to read as follows:

§31.3406(a)-1 Withholding requirement on reportable payments made after December 31, 1983 [Reserved]

§31.3406(a)-2 The obligation of payors to backup withhold [Reserved]

§31.3406(a)-3 Accounts subject to backup withholding

(a) *Application of backup withholding to certain reportable payments made outside the United States by foreign persons, foreign offices of United States banks and brokers, and others.* [Reserved]

(b) *Exemptions from backup withholding.* The following payments are exempt from backup withholding under section 3406(a):

(1) A payment of interest or original issue discount described in §1.6049-5(e)(2);

(2) A transfer by a middleman (as defined by §1.6049-4(f)(4)(i)) from within the United States of an interest coupon or discount obligation on behalf of a payee for presentation, collection or payment outside the United States; and

(3) A payment of interest or principal by an international organization (as described in §1.6049-4(c)(1)(ii)(G)) with respect to an obligation of which it is the issuer provided the organization is an organization of which the United States is a member and which enjoys immunity or exemption from any liability or obligation to pay, withhold or collect tax pursuant to an international agreement having full force and effect in the United States (or its paying, transfer, or other agent that is not also a payee's agent).

(c) *Application of backup withholding to joint foreign payees.* Although generally any payment made to joint payees shall be treated as if the entire payment were to the first person listed on the account or instrument giving rise to the payment, this general rule does not apply if the first payee listed on an account or instrument provides the penalties of perjury statement as to its foreign status (as described in §1.6049-5(g) with respect to interest and original issue discount and §1.6045-1(g)(3)(i) with respect to broker transactions). In such a case, backup withholding shall apply unless—

(1) every joint payee provides the statement as to foreign status, or

(2) any one of the joint payees who has not established foreign status provides a taxpayer identification number of the payor in the manner required in regulations under section 3406.

If any one of the joint payees who has not established foreign status provides a taxpayer identification number in the manner required in regulations under section 3406, such number is the taxpayer identification number that is required to be furnished for purposes of information reporting and backup withholding.

* * * * *

PART 35a—TEMPORARY REGS. CONCERNING BACKUP WITHHOLDING

Par. 22. The authority for Part 35a continues to read as follows:

Authority: 26 U.S.C. 7805; §35a.9999-3 also issued under 26 U.S.C. 3406(a), (b), (c), (e), (g), (h), and (i) and sec. 6045; §35a.9999-3A also issued under 26 U.S.C. 3406(b), (g), (h), and (i) and sec. 6045; §35a.9999-4T also issued under 26 U.S.C. 3406 and secs. 6041, 6045, 6049; §35a.9999-5 also issued under 26 U.S.C. 871 and secs. 881,. 1441, 1442, 3406, 6041, 6045, 6049.

Par. 23. Part 35a is amended by—

1. Removing and reserving Question and Answers 31, 33, 34, 35, 36, and 37 of §35a.9999-3,
2. Removing and reserving §34a.9999-3A,
3. Removing and reserving Question and Answers 1, 2, 4, and 5 of §35a.9999-4T, and
4. Removing and reserving Question and Answers 2, 3, 4, 5, 6, 7, 11, and 17 of §35a.9999-5.

* * * * *

Lawrence B. Gibbs,
Commissioner of the
Internal Revenue.

(Filed by the Office of the Federal Register on February 26, 1988, 8:45 A.M., and published in the issue of the Federal Register for February 29, 1988, 53 F.R. 5286)

Notice of Proposed Rulemaking

Section 904(f) Transition Rules

INTL-932-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: This document contains proposed regulations relating to transition rules with respect to implementing the changes made to section 904(f) of the Internal Revenue Code of 1954 by the Tax Reform of 1986 [1987-3 (Vol.1) C.B.1]. The regulations would provide the public with guidance needed to comply with that Act and would affect individuals and entities claiming the foreign tax credit.

DATES: Written comments and request for a public hearing must be delivered or mailed by July 18, 1988. The amendments are proposed to be effective for taxable years beginning after December 31, 1986.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention CC:LR:T (INTL-932-86), Washington, DC 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary regulations published in [T.D. 8201, page 291, this Bulletin] adds new §1.904(f)-13T. The final regulations that are proposed to be based on the temporary regulations would amend 26 CFR Part 1. For the text of the temporary regulations, see T.D.8201, published in *** [page 291, this Bulletin].

EXECUTIVE ORDER 12291 and REGULATORY FLEXIBILITY ACT

The Commissioner of Internal Revenue has determined that these proposed rules are not major rules as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. Although this document is a notice of a proposed rulemaking which solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

LIST OF SUBJECTS IN 26 CFR §§1.861.1 through 1.997-1

Income taxes, Corporate deductions, Aliens, Exports, DISC, Foreign investments in U.S., Foreign tax credit, FSC, Source of income, U.S. investments abroad.

Proposal of regulations

The temporary regulations, T.D. 8201, published in *** [page 291, this

Bulletin] are hereby also proposed as final regulations under section 904(f) of the Internal Revenue Code of 1986.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on May 16, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 17, 1988, 53 F.R. 17472)

Notice of Proposed Regulations

Elections Under Sections 1291, 1294, 1295 and 1297 of the Internal Revenue Code

INTL-941-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In *** [T.D. 8178, page 313, this Bulletin], the Internal Revenue Service is issuing temporary income tax regulations relating to elections by passive foreign investment companies and their shareholders who are United States persons. The text of the temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: The regulations are proposed to be effective for taxable years beginning after December 31, 1986. Written comments and requests for a public hearing must be delivered or mailed by May 5, 1988.

ADDRESS: Send comments and requests for a public hearing to Commissioner of Internal Revenue, Attention: CC:LR:T (CC:INTL-941-86), Washington, DC 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document provides proposed income tax regulations (26 CFR Part 1) under sections 1291(d)(2), 1294, 1295, and 1297(b)(1) of the Internal Revenue Code of 1986. These provisions were added to the Internal Revenue Code by section 1235 of the Tax Reform Act of 1986 (Pub. L. 99-514). The regulations will be effective for taxable years beginning after 1986. For the text of the temporary regulations, see T.D. 8178 *** [page 313, this Bulletin]. The preamble to the temporary regulations provides a discussion of the rules.

SPECIAL ANALYSES

It has been determined that this proposed rule is not a major rule as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required and has not been prepared. Although this document is a notice of proposed rulemaking that solicits public comment, it has been concluded that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before these temporary and proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted (preferably seven copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER. The collection of information requirements contained herein have been submitted to the Office of Management and Budget (OMB) for review under section 3504(h) of the Paperwork Reduction Act. Comments on the requirements should be sent to the Office of Information and Regulatory Affairs of OMB, Attention: Desk Officer for Internal Revenue Service, New Executive Office Building, Washington, DC 20503. The Internal Revenue Service requests persons submitting comments to OMB to also send copies of the comments to the Service.

* * * * *

Proposal of regulations

The temporary regulations, *** [T.D. 8178, page 313, this Bulletin] are hereby also proposed as final regulations under sections 1291, 1294, 1295, and 1297 of the Internal Revenue Code.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue

(Filed by the Office of the Federal Register on February 26, 1988, 8:45 a.m., and published in the issue of the Federal Register of March 2, 1988, 53 F.R. 6781)

Notice of Proposed Rulemaking

Registration Requirements with Respect to Certain Debt Obligations; Sanctions on Issuers of Registration-Required Obligations Not in Registered Form

INTL-990-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: This document provides a notice of proposed rulemaking relating to the definition of the term "registration-required obligations" with respect to pass-through certificates and the application of the sanctions on issuers of "registration-required obligations" not in registered form to the issuers of such certificates. In *** [T.D. 8202, page 78, this Bulletin], the Internal Revenue Service is issuing temporary income tax regulations with respect to this subject. The text of these temporary regulations serves as the comment document for this notice of proposed rulemaking.

DATE: Written comments and requests for a public hearing must be delivered or mailed by July 18, 1988.

ADDRESS: Send comments and requests for public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (INTL-990-86), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

Section 1.163-5T(d) was deleted by T.D. 8110 [1987-1 C.B. 81], which was published on December 19, 1986, in the Federal Register at 51 FR 45453 when all of §1.163-5T was removed. Paragraph (d) is being replaced retroactively into the regulations §1.163-5T(d) (with prior paragraphs reserved) through temporary regulations published in *** [T.D. 8202, page 78, this Bulletin].

REGULATORY FLEXIBILITY ACT AND EXECUTIVE ORDER 12291

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. Although this document is a notice of proposed rulemaking which solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations as final regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

LIST OF SUBJECTS IN 26 CFR 1.16 through 1.281-4

Income taxes, Taxable income, Deductions, Exemptions

Proposal of Regulations

The temporary regulations, FR Doc. [T.D. 8202] published in *** [page 78, this Bulletin], are hereby also proposed as final regulations under section 163 of the Internal Revenue Code of 1954.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on May 18, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 19, 1988, 53 F.R. 17959)

Notice of Proposed Rulemaking

Apportionment of Expenses in the FSC and DISC Contexts

INTL-128-87

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed Income Tax Regulations relating to apportionment of expenses in the FSC and DISC contexts.

DATES: Written comments and requests for a public hearing must be delivered or mailed by July 18, 1988. The amendments are proposed to be effective for taxable years beginning after December 31, 1986.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T [INTL-28-86], Washington, DC 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 861(b) of the Internal Revenue Code.

DISCUSSION

These regulations modify §1.861-8 (f)(1)(vi)(C) to provide that expenses, losses and other deductions that have been properly allocated and apportioned between combined gross income of a related supplier and a DISC or FSC from an export transaction and residual gross income are not also allocated and apportioned to gross income consisting of certain distributions from the DISC or FSC. A new *Example* (23) is added to §1.861-8(g) by these regulations to reflect this change. Specifically, new *Example* (23) illustrates how a related supplier's general and administrative expenses are apportioned to its various classes of gross income if the related supplier pays commissions to the FSC on export sales. In contrast to the apportionment of general and administrative expenses in existing *Example* (22) of §1.861-8(g) which involves an export sale made through a DISC, new *Example* (23) illustrates that there is not a second stage apportionment to FSC dividends attributable to the FSC's foreign trade income (except to the extent that the foreign trade income is determined under the section 925(a)(3) transfer pricing method) of the related supplier's general and administrative expenses that have already been apportioned to the combined taxable income of the FSC and the related supplier. The example also illustrates that the related supplier's research and development expenses are apportioned in a like manner.

In addition, new *Example* (23) of §1.861-8(g) illustrates that in the DISC context, there will not be a second stage apportionment to DISC dividends of the related supplier's expenses that have already been apportioned to the combined taxable income of the DISC and the related supplier. Existing *Example* (22) of §1.861(g) applies only with regard to taxable years beginning before January 1, 1987.

New *Example* (23) does not apply to corporations electing the application of section 936.

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting as final regulations these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is to be held, notice of the time and place will be published in the Federal Register.

SPECIAL ANALYSES

Although this document is a notice of proposed rulemaking which solicits public comment, it has been concluded that the proposed regulations are interpretative and that the notice and public comment procedural requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6). It has been determined that this proposed rule is not a major legislative regulation subject to Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required.

LIST OF SUBJECTS IN 26 CFR §§1.861-1 through 1.997-1

Income taxes, Aliens, Exports, DISC, Foreign investment in U.S., Foreign tax credit, FSC, Sources of income, United States investments abroad.

Proposed amendments to the regulations

Accordingly, the proposed amendments to 26 CFR Part 1 are as follows:

INCOME TAX REGULATIONS
(26 CFR Part 1)

Paragraph 1. The authority for Part 1 continues to read in part:

Authority: 26 U.S.C. 7805. ***

Par. 2. Section 1.861-8(f)(1)(iii) and (vi)(C) is revised to read as follows:

§1.861-8. Computation of taxable income from sources within the United States and from other sources and activities.

* * * * *

(f) *Miscellaneous matters*—(1) *Operative sections.* ***

(iii) *DISC and FSC taxable income.* Sections 925 and 994 provide rules for determining the taxable income of a FSC and DISC, respectively, with respect to qualified sales and leases of export property and qualified services. The combined taxable income method available for making determination of a DISC's taxable income provides, without consideration of export promotion expenses, that the taxable income of the DISC shall be 50 percent of the combined taxable income of the DISC and the related supplier derived from sales and leases of export property and from services. In the FSC context, the taxable income of the FSC equals 23 percent of the combined taxable income of the FSC and the related supplier. Pursuant to regulations under sections 925 and 994, this section provides rules for determining the deductions to be taken into account in determining combined taxable income, except to the extent modified by the marginal costing rules set forth in the regulations under sections 925(b)(2) and 994(b)(2) if used by the taxpayer as provided therein. See *Examples* (22) and (23) of paragraph (g) of this section. In addition, the computation of combined taxable income is necessary to determine the applicability of the section 925(d) limitation and the "no loss" rules of the regulations under sections 925 and 994.

* * * * *

(vi) ***

(C) The amount of interest income and the income from certain distributions from a DISC or former DISC to which the foreign tax credit limitation is applied separately under section 904(d) (as in effect after enactment of the Tax Reform Act of 1976). In the case of expenses, losses, and other deductions that have been properly allocated and apportioned between combined gross income of a related supplier and a DISC or former DISC under section 994 and residual gross income, such deductions are not also allocated and apportioned to gross income consisting of certain distributions from the DISC or former DISC with respect to DISC or former DISC taxable years beginning after December 31, 1986. Accordingly, *Example* (22) of paragraph (g) of this section does not apply to distributions from a DISC or former DISC with respect to DISC or former DISC taxable years beginning after December 31, 1986. In addition, for taxable years beginning after December 31, 1986, in the case of expenses, losses, and other deductions that have been properly allocated and apportioned between combined gross income of a related supplier and a FSC under section 925 and residual gross income, such deductions are not also allocated and apportioned to gross income consisting of distributions from the FSC or former FSC which are attributable to the foreign trade income of the FSC or former FSC (except to the extent that the foreign trade income is determined under the section 925(a)(3) transfer pricing method). See *Example* (23) of paragraph (g) of this section;

* * * * *

Par. 3. *Example* (22) of §1.861-8(g) is amended by adding immediately after subdivision (iii) a subdivision (iv) to read as follows:

§1.861-8. Computation of taxable income from sources within the United States and from other sources and activities.

* * * * *

(g) *General examples.* ***

Example (22). ***

(iv) This *Example* (22) applies only to DISC taxable years ending before January 1, 1987, and to distributions from a DISC or former DISC with respect to DISC or former DISC taxable years ending before January 1, 1987.

* * * * *

Par. 4. *Example* (23) of §1.861-8(g) is removed and replaced with new *Example* (23) to read as follows:

§1.861-8. Computation of taxable income from sources within the United States and from other sources and activities.

* * * * *

(g) *General examples.* ***

Example (23)—Foreign Sales Corporations—(i) *Facts.* R, a domestic corporation, manufactures a product line of electronic equipment and sells it to retailers both in the United States and in foreign countries through foreign sales branches. On January 1, 1988, R established FSC, a wholly owned corporation, in a possession of the United States. FSC elected under section 922(a)(2) foreign sales corporation status. Both R and FSC are calendar year corporations. R entered into a written agreement with FSC whereby FSC was granted a sales franchise with respect to the export sales of the electronic equipment, which is export property as defined in section 927(a). Under the agreement, FSC would receive commissions with respect to those exports equal to the maximum amount permitted to be received under the administrative pricing rules of section 925(a)(1) and (2). The maximum amount will equal the expenses incurred by FSC plus the maximum profit permitted to be earned by FSC under the pricing rules. In 1987, the profit earned by FSC was $354,424. This profit was determined using the combined taxable income administrative pricing method of section 925(a)(2). FSC paid taxes to the United States in the amount of $41,914 (*i.e.*, $354,424 × 8/23 × .34). The FSC did not pay any foreign tax. On September 15, 1989, FSC paid R a dividend of $312,510 (*i.e.*, profit less United States tax). The 100% dividends received deduction of section 245(c) applied to this dividend. In 1988, R had total export sales of $7,700,000 for which its cost of goods sold was $6,000,000. Thus, its gross income on those sales was $1,700,000. Those sales occurred outside the United States. Moreover, R had U.S. domestic sales of $12,000,000 on which it earned gross income of $900,000. R received royalty income from the foreign license of its electronic technology in the amount of $1,000,000. R's deductible general and administrative expenses allocable to all gross income are $125,000. For purposes of this example, it is assumed that R did not incur any research and development expenses. In addition, it is assumed that R did not incur any direct selling expenses with respect to either its domestic or foreign sales. FSC incurred $100,000 of expenses relating to the activities and functions referred to in section 924(c), (d) and (e). FSC will receive the maximum commission and profit under the combined taxable income method of section 925(a)(2). Under this method, FSC will receive a profit equal to 23% of the combined taxable income attributable to the export sale of the electronic equipment computed on a product line basis.

(ii) *Allocation.* For purposes of determining combined taxable income of R and FSC from export sales, R's general and administrative expenses of $125,000 must be allocated to and apportioned between gross income resulting from the production and sale of the electronic equipment for foreign markets, and from the production and sale of the electronic equipment for the domestic market.

(iii) *Apportionment*—(A) *Combined Taxable Income.* In order to compute the combined taxable income from the production and sale of the electronic equipment, R's general and administrative expenses of $125,000 are apportioned between the statutory grouping of gross income under section 863(b) from the export of the electronic equipment and the residual grouping of gross income from domestic sales and foreign licenses. None of R's general and administrative expenses are apportioned to the FSC distribution of $312,510. In the absence of more specific or contrary information, R's general and administrative expenses may be apportioned on the basis of gross income in the respective groupings, as follows:

Apportionment of general and administrative expenses to the section 863(b) statutory grouping, gross income from exports of electronic equipment:

$$\$125{,}000 \text{ X } \frac{\$1{,}700{,}000}{(\$1{,}700{,}000 + \$900{,}000 + \$1{,}000{,}000)} = \qquad \$\ 59{,}028$$

Apportionment of general and administrative expenses to the residual grouping, gross income from domestic sales of electronic equipment, foreign royalty income from licensing electronic equipment technology:

$$\$125{,}000 \text{ X } \frac{(\$900{,}000 + \$1{,}000{,}000)}{(\$1{,}700{,}000 + \$900{,}000 + \$1{,}000{,}000)} = \qquad \$\ 65{,}972$$

Total apportionment of general and administrative expenses	$ 125,000

On the basis of this apportionment, the combined taxable income and FSC's portion of the combined taxable income may be calculated as follows:

Gross income from exports		$1,700,000
Less: FSC section 924(c), (d) and (e) expenses........	$100,000	
Apportioned general and administrative expenses........	59,028	
Total expenses		(159,028)
Combined taxable income........		$1,540,972
FSC's income— 23% of combined taxable income........		$ 354,424

(B) ***R's section 863(b) taxable income.*** R's total section 863(b) taxable income from the export sales equals 77% of combined taxable income and is computed as follows:

Gross receipts........	$7,700,000
Cost of goods sold	6,000,000
Gross income	1,700,000
Less:	
Apportioned general and administrative expenses........	59,028
Commission to FSC	454,424
Total	(513,452)
R's taxable income	$1,186,548

As illustrated, all of the general and administrative expenses apportioned to combined taxable income are taken as deductions in computing R's section 863(b) taxable income.

(C) ***R's foreign source royalty income.*** In order to determine the amount of taxable income of R from sources without the United States relating to the royalty income, the remaining general and administrative expenses of $65,972 are apportioned between the statutory grouping, foreign royalty income, and the residual grouping of gross income from sources within the United States. The computations below illustrate this apportionment:

Apportionment of the general and administrative expenses to the statutory grouping, foreign royalty income:

$$\$65{,}972 \text{ X } \frac{\$1{,}000{,}000}{(\$1{,}000{,}000 + \$900{,}000)} = \qquad \$34{,}722$$

Apportionment of the general and administrative expenses to the residual grouping, gross income from domestic sales of electronic equipment:

$$\$65{,}972 \text{ X } \frac{\$900{,}000}{(\$1{,}000{,}000 + \$900{,}000)} = \qquad \$31{,}250$$

(iv) *R's foreign source income from the sales using FSC as a commission agent.* R's section 863(b) income of $1,186,548 from the export sales of electronic equipment manufactured in the United States and sold in foreign countries will qualify for sourcing partly from within and partly from without the United States in accordance with §1.863-3. For purposes of this example, it is assumed that R's income is sourced on the basis of *Example* (2) of §1.863-3(b)(2). Accordingly, one-half of the income ($593,274) would qualify as foreign source income. However, since the export sales were made using a foreign sales corporation as a commission agent on the sale, section 927(e)(1) will operate to limit R's foreign source income to $385,243. Under section 927(e)(1), R's foreign source income on the export transaction may not exceed the amount which would have been treated as foreign source income had the comparable DISC pricing rule, in this case the 50% of combined taxable income method, been used to compute FSC's profit. The calculations under section 927(e)(1) are as follows (for purposes of this example, it is assumed that there are no export promotion expenses):

Combined Taxable Income (CTI)	$1,540,972
DISC income (50% of CTI)	770,486
R's income (50% of CTI)	770,486
Source of R's income:	
U.S. source	$ 385,243
Foreign source	$ 385,243

(v) *Research and development expenses.* For purposes of this example, it was assumed R did not incur any research and development expenses (R & D expenses). Had R incurred R & D expenses, for purposes of computing the combined taxable income from the production and sale of the electronic equipment, those R & D expenses would have been allocated and apportioned between the statutory grouping of gross income from the export of the electronic equipment and the residual grouping of gross income from domestic sales and foreign licenses. R & D expenses would also have been apportioned to R's export sales and royalty income in order to determine R's section 863(b) taxable income from export sales. As with the apportionment of general and administrative expenses, none of the R & D expenses are apportioned to the dividends from the FSC.

(vi) *Apportionment of expenses in a DISC context.* For taxable years beginning after December 31, 1986, general and administrative expenses and research and development expenses of a related supplier in a DISC context are also allocated and apportioned as illustrated in this example. None of the expenses are apportioned to DISC dividends.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on May 16, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 17, 1988, 53 F.R. 17473)

Notice of Proposed Rulemaking

Consent Dividends

INTL-313-87

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: *** [page 254, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to the consent dividend provisions of section 565 of the Internal Revenue Code of 1986. The text of the temporary regulations is the comment document for this notice of proposed rulemaking.

DATES: Written comments and requests for a public hearing must be delivered or mailed by February 16, 1988.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, 1111 Constitution Ave., N.W., Washington, D.C. 20024. Attention:CC:LR:T (INTL-313-87).

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary regulations *** [page 254, this Bulletin], amend the Income Tax Regulations under the consent dividend provisions of section 565 of the Internal Revenue Code of 1986. The final regulations which this document proposes to be based on those temporary regulations, would amend section 1.565 of Part 1 of Title 26 of the Code of Federal Regulations. For the text of the temporary regulations see FR Doc. [TD 8166] [page 254, this Bulletin]. The preamble to the temporary regulations explains the changes to the Income Tax Regulations.

The proposed regulations provide needed guidance regarding policy changes prompted by a reconsideration of certain provisions of the regulations under section 565.

NON-APPLICABILITY OF EXECUTIVE ORDER 12291

It has been determined that this proposed rule is not a major rule as defined in Executive Order 12291. Accordingly, a regulatory impact analysis is not required.

REGULATORY FLEXIBILITY ACT

Although this document is a notice of proposed rulemaking that solicits public comment, it has been determined that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, this proposed regulation does not constitute a regulation subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register. The collection of information requirements contained herein have been submitted to the Office of Management and Budget (OMB) for review under section 3504(h) of the Paperwork Reduction Act. Comments on the requirements should be sent to the Office of Information and Regulatory Affairs of OMB, Attention: Desk Officer for Internal Revenue Service, New Executive Office Building, Washington, DC 20503. The Internal Revenue Service requests that persons submitting comments to OMB also send copies of the comments to the Service.

* * * * *

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on December 11, 1987, 9:13 a.m., and published in the issue of the Federal Register for December 15, 1987, 52 F.R. 47609).

Notice of Proposed Rulemaking

Corporate Distributions and Certain Nonrecognition Exchanges and Other Transfers Under Section 897(c), (d), (e), (g), (i) and (j) and Section 367(e)(2) and Withholding Under Section 1445(e)(5) and (6)

INTL-491-87

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In *** [T.D. 8198, page 270, this Bulletin], the Internal Revenue Service is issuing temporary regulations that add new §§1.897-4AT, 1.897-5T, 1.897-6T, 1.897-7T, 1.897-8T and 1.897-9T relating to corporate distributions and certain nonrecognition exchanges, and new §§1.1445-9T and 1.1445-10T relating to certain withholding provisions, all in the context of the Foreign Investment in Real Property Tax Act (FIRPTA). In addition, the regulations provide rules with respect to the treatment of interests in publicly traded corporations. The text of the temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: Written comments and requests for a public hearing must be delivered or mailed before July 5, 1988.

Except as otherwise specifically provided, §§1.897-4AT, 1.897-5T, and 1.897-6T are proposed to apply to exchanges, distributions, or transfers of U.S. real property interests occurring after June 18, 1980. Although these regulations are proposed to be applied as of June 18, 1980, it is anticipated that any taxpayer desiring to apply the temporary regulations in lieu of the final regulations for the period prior to the adoption of the final regulations will be allowed to so choose. All changes and additions to portions of the existing regulations are made by §§1.897-7T, 1.897-8T, 1.897-9T except paragraph (e) 1.1445-10T, and 1.1445-11T proposed to be generally effective after June 6, 1988. Paragraph (e) of §1.897-9T dealing with foreign governments and international organizations is effective July 1, 1986. The special rules of §1.1445-9T for section 1034 nonrecognition are effective after August 3, 1988.

ADDRESS: Send comments and requests for a public hearing to Commissioner of Internal Revenue, Attention: CC:LR:T (INTL-491-87), Washington, DC 20224.

SUPPLEMENTARY INFORMATION:

Background

The temporary regulations published in *** [T.D. 8198, page 270, this Bulletin] add §§1.897-4AT, 1.897-5T, 1.897-6T, 1.897-7T, 1.897-8T, 1.897-9T, 1.1445-9T and 1.1445-10T to 26 CFR Part 1. The final regulations that are proposed to be based on these temporary regulations would amend 26 CFR Part 1 by adding these temporary regulations sections as final regulations under section 897(c), (d), (e), (g), and (j), under the authority of section 367(e)(2), and under section 1445 of the Internal Revenue Code of 1986. For the text of the temporary regulations, see T.D. 8198 published in *** [page 270, this Bulletin].

Special Analyses

It has been determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. It has also been determined that this rule will not have a significant impact on a substantial number of small entities. Few small entities would be affected by these regulations. A regulatory flexibility analysis, therefore, is not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6).

Comments and Requests for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

The collection of information requirements contained herein have been submitted to the Office of Management and Budget (OMB) for review under section 3504(h) of the Paperwork Reduction Act. Comments on the requirements should be sent to the Office of Information and Regulatory Affairs of OMB, Attention: Desk Office for Internal Revenue Service, New Executive Office Building, Washington, DC 20503. The Internal Revenue Service requests persons submitting comments to OMB to also send copies of the comments to the Service.

List of Subjects

26 CFR 1.861-1 to 1.997-1

Income taxes, Aliens, Exports, DISC, Foreign Investment in U.S., Foreign tax credit, FSC, Sources of income, United States investments abroad.

26 CFR 1.1441-1 to 1.1465-1

Income taxes, Aliens, Foreign corporations.

26 CFR Part 602

Reporting and recordkeeping requirements.

* * * * *

Proposal of regulations

The temporary regulations, T.D. 8198 published in *** [page 270, this Bulletin], are hereby also proposed as final regulations under sections 897 and 1445 of the Internal Revenue Code of 1986.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on May 4, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 5, 1988, 53 F.R. 16233)

Notice of Proposed Rulemaking

Registration Requirements With Respect to Certain Debt Obligations; Sanctions on Issuers of Registration Required Obligations Not in Registered Form

INTL-905-87

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document provides a notice of proposed rulemaking relating to the application of the sanctions on issuers of registration required obligations not in registered form. These regulations would provide the public with guidance necessary to comply with the Tax Equity and Fiscal Responsibility Act of 1982.

DATES: Written comments and requests for a public hearing must be delivered or mailed before July 18, 1988. These regulations are proposed to be applicable to the transfers of obligations occurring after August 17, 1988.

ADDRESS: Send comments and request for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (INTL-905-87), Washington, DC 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

Section 4701 imposes a tax on issuers of "registration-required obligations" not in registered form. Section 5f.103-1(c)(1) provides generally that an obligation is in registered form if it is registered with the issuer (or its agent) and may be transferred by surrender and reissuance by the issuer (or its agent), or through a book entry system maintained by the issuer (or its agent), or through both of these methods.

EXPLANATION OF PROVISIONS

An issuer or its agent may have no knowledge or control over the method of transfer of an obligation that is held by a nominee. A new paragraph (d)(7) of §1.163-5T has been proposed to provide explicitly for the application of section 4701 to circumstances in which a holder transfers an obligation through a method not described in §5f.103-1(c)(1).

Section 1.163-5T(d)(7) of these proposed regulations provides, pursuant to §46.4701-1(a)(5), that any person who holds a registration required obligation that is in registered form within the meaning of §5f.103-1(c)(1) and who transfers the obligation through a method not described in §5f.103-1(c)(1) is considered the issuer of the obligations transferred for purposes of section 4701. Such transferor is therefore subject to the tax imposed under section 4701, even though he may not be the person whose interest deduction would be disallowed by reason of section 163(f)(1). Such transferor is considered to have issued the obligation on the date of the transfer in the principal amount of the obligation transferred. Section 1.163-5T(d)(7) would apply to transfers occurring after August 17, 1988.

SPECIAL ANALYSES

It has been determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. Although this document is a notice of proposed rulemaking that solicits public comments, it has been determined that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6) and a Regulatory Flexibility Analysis has not been prepared.

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting final regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

* * * * *

Proposed amendments to the regulations

Accordingly, the proposed amendments to 26 CFR Part 1 are as follows:

INCOME TAX REGULATIONS (26 CFR PART 1)

Paragraph 1. The authority for Part 1 continues to read in part:

Authority: 26 U.S.C. 7805. ***

Par. 2. Paragraph (d)(7) is added immediately after paragraph (d)(6) of §1.163-5T. The added paragraph reads as follows:

§1.163-5T Denial of interest deduction on certain obligations issued after December 31, 1982, unless issued in registered form (temporary).

(d) *Pass-through certificates.*

* * * * *

(7)(i) For purposes of section 4701, any person who holds a registration-required obligation that is in registered form within the meaning of §5f.103-1(c)(1) and transfers the obligation through a method not described in §5f.103-1(c)(1) is considered to have issued the obligation so transferred on the date of the transfer in the principal amount of the obligation received by the transferee. Such person is therefore liable for any excise tax under section 4701 that may be imposed. This paragraph (d)(7) applies to transfers of obligations occurring after August 17, 1988.

(ii) The provisions of this paragraph (d)(7) may be illustrated by the following examples:

Example (1). X, a corporation, holds a registration required obligation in registered form in the principal amount of 10x with a maturity date of December 31, 1999. X transfers the obligation through a method not described in §5f.103-1(c)(1) on June 30, 1990. For purposes of section 4701, X is considered to have issued an obligation on June 30, 1990 in the principal amount of 10x with a maturity date of December 31, 1999. Because X has issued a registration required obligation not in registered form, X is liable for the tax imposed by section 4701 in an amount computed with reference to the principal amount of 10x and the period beginning on June 30, 1990 and ending on December 31, 1999.

Example (2). X, a corporation, holds a registration required obligation in registered form as nominee of Y, a corporation. The principal amount of the obligation is 10x and the maturity date of the obligation is December 31, 1999. On June 30, 1990, X issued a bearer receipt to Y for the obligation. For purposes of section 4701, X is considered to have issued an obligation on June 1990 in the principal amount of 10x with a maturity date of December 31, 1999. Because X has issued a registration required obligation not in registered form, X is liable for the tax imposed by section 4701 in an amount computed with reference to the principal amount of 10x and the period beginning June 30, 1990 and ending December 31, 1999.

Example (3). The facts are the same as in *Example (1)* except that X transfers 5x of the 10x obligation held by X. X is considered to have issued an obligation on June 30, 1990 in the principal amount of 5x with a maturity date of December 31, 1999. Because X has issued a registration required-obligation not in registered form, X is liable for the tax imposed by section 4701 in an amount computed with reference to the principal amount of 5x and the period beginning on June 30, 1990 and ending on December 31, 1999.

Example (4). The facts are the same as in *Example (1)* except that X is a natural person. X is considered to have issued an obligation on June 30, 1990 in the principal amount of 10x with a maturity date of December 31, 1999. Because X is a natural person, the obligation is not a registration required obligation and, therefore, X is not subject to the tax imposed under section 4701.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on May 18, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 19, 1988, 53 F.R. 17960)

Notice of Proposed Rulemaking

Excise Tax on Heavy Trucks, Truck Trailers and Semitrailers, and Tractors

LR-17-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In *** [T.D. 8200, page 351, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to the excise tax imposed on the first retail sale of heavy trucks, truck trailers and semitrailers, and tractors. The text of the temporary regulations also serves as the text for this Notice of Proposed Rulemaking.

DATES: Written comments and requests for a public hearing must be delivered or mailed July 11, 1988.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-17-86), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary regulations in *** [T.D. 8200, page 351, this Bulletin], amend Part 145 Title 26 of the Code of Federal Regulations. The final regulations which are proposed to be based on the temporary regulations would amend Part 48 of Title 26 of the Code of Federal Regulations. The regulations provide guidance relating to the definition of the term "first retail sale" under section 4052(a)(1) of the Internal Revenue Code of 1986 (Code) as amended by section 505 of the Highway Revenue Act of 1987 (Title V of the Surface Transportation and Uniform Relocation Assistance Act of 1987) (Pub. L. 97-424, 101 Stat. 258). The regulations also provide rules relating to the determination of the price of an article in the case of (1) a long-term lease and (2) a retail sale by a manufacturer, producer, or importer under section 4052(b)(3) and (4) of the Code as added by sections 505 and 506, respectively, of the Highway Revenue Act of 1987 (Title 5 of the Surface Transportation and Uniform Relocation Assistance Act of 1987 (Pub. L. 97-424, 101 Stat. 258). For the text of the temporary regulations see T.D. 8200 *** [page 351, this Bulletin]. The preamble to the temporary regulations provides a discussion of the rules.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. Although this document is a notice of proposed rulemaking that solicits public comment, the Internal Revenue Service has concluded that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the *Federal Register.*

LIST OF SUBJECTS IN 26 CFR Part 48

Agriculture, Arms and munitions, Coal, Excise taxes, Gasohol, Gasoline, Motor vehicles, Petroleum, Sporting goods, Tires.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on May 11, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 12, 1988, 53 F.R. 16882).

Notice of Proposed Rulemaking

2-Percent Floor on Miscellaneous Itemized Deductions

LR-97-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: *** [T.D. 8189, page 24, this Bulletin], the Internal Revenue Service is issuing temporary income tax regulations relating to the 2-percent floor on miscellaneous itemized deductions. The text of the temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES:

PROPOSED EFFECTIVE DATE

The regulations are proposed to be effective for taxable years beginning after December 31, 1986.

DATES FOR COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Written comments and requests for a public hearing must be delivered or mailed by May 27, 1988.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-97-86) Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary regulations *** amend the Income Tax Regulations (26 CFR Part 1) to provide rules under section 67.

For the text of the temporary regulations, see T.D. 8189, *** [page 24, this Bulletin]. The preamble to the temporary regulations explains the addition to the regulations.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. Although this document is a notice of proposed rulemaking that solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably seven copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of time and place will be published in the FEDERAL REGISTER. The collection of information requirements contained herein have been submitted for OMB review under the Paperwork Reduction Act, and comments on them should be sent to the Office of Information and Regulatory Affairs of OMB, ATTN: Desk Office for Internal Revenue Service, New Executive Office Bldg., Washington, D.C. 20503. The Internal Revenue Service requests persons submitting comments to OMB to also send copies of the comments to the Service.

LIST OF SUBJECTS IN 26 CFR 1.61-1 through 1.281-4

Income taxes, Taxable income, Deductions, Exemptions

These amendments are necessary because of the addition of section 67 to the Code by section 132 of Pub. L. 99-514 (100 Stat. 2113). These regulations are proposed to be issued under the authority contained in sections 67 (c) and 7805 of the Internal Revenue Code of 1986 (100 Stat. 2114, 26 U.S.C. 67 (c); 68A Stat. 917, 26 U.S.C. 7805, respectively).

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on March 25, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 28, 1988, 53 F.R. 9951)

Notice of Proposed Rulemaking

Taxable Years of Certain Partnerships

LR-101-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: ***, [t]he Internal Revenue Service is issuing temporary income tax regulations [page 259, this Bulletin] relating to the taxable years of certain partnerships. The text of the temporary regulations serves as the comment document for this notice of proposed rulemaking.

DATES:

PROPOSED EFFECTIVE DATE

The proposed amendments to the Income Tax Regulations contained in this document would be effective for partnership taxable years beginning after December 31, 1986.

DATES FOR COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Written comments and requests for a public hearing must be delivered or mailed by February 29, 1988.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-101-86) Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary regulations *** [page 259, this Bulletin], amend the Income Tax Regulations (26 CFR Part 1) under section 706.

For the text of the temporary regulations see T.D. 8169 *** [page 259, this Bulletin]. The preamble to the temporary regulations explains the addition to the regulations.

REGULATORY FLEXIBILITY ACT AND EXECUTIVE ORDER 12291

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. Although this document is a notice of proposed rulemaking that solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 24, 1987, 9:09 a.m., and published in the issue of the Federal Register on December 29, 1987, 52 F.R. 49030)

Notice of Proposed Rulemaking

Election to Have Certain Diesel Fuel Taxes Imposed on Sales to Retailers

LR-114-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In *** [T.D. 8181, page 344, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to the collection of excise taxes on diesel fuel under an election provided by section 4041(n) of the Code. The text of the temporary regulations also serves as the text for this notice of proposed rulemaking.

DATES: Written comments and requests for a public hearing must be delivered or mailed by May 2, 1988. The regulations are proposed to be effective and apply to sales of diesel fuel for use in diesel-powered highway vehicles made after March 31, 1987, and before April 1, 1988, with the exception of the following provisions, which are proposed to be effective as of March 1, 1988:

§48.4041-21(g);

§48.4041-21(h)(1) following "section 4041(a)(1),";

§48.4041-21(h)(2);

§48.4041-21(i)(3); and

§48.4041-21(k)(1).

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-114-86), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION

BACKGROUND

The temporary regulations in *** [T.D. 8181 page 344, this Bulletin] amend Part 48 of Title 26 of the Code of Federal Regulations. The temporary regulations are designated by a "T" following their section citation. The final regulations which are proposed to be based on the temporary regulations would amend Part 48 of Title 26 of the Code of Federal Regulations. The regulations provide rules relating to an election to shift the diesel fuel excise tax from the retailer to the wholesaler of the fuel under section 4041(n) of the Internal Revenue Code of 1986 (Code) as added by section 1702 of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2773). The regulations do not reflect changes made to the diesel fuel excise tax by the Revenue Act of 1987 (Pub. L. 101-203, 101 Stat. 1330).

For the text of the temporary regulations, see T.D. 8181 [page 344, this Bulletin]. The preamble to the temporary regulations provides a discussion of the rules.

SPECIAL ANALYSIS

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required. Although this document is a notice of proposed rulemaking that solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

The collection of information requirements contained herein have been submitted to the Office of Management and Budget (OMB) for review under section 3504(h) of the Paperwork Reduction Act. Comments on the requirements should be sent to the Office of Information and Regulatory Affairs of OMB; Attention: Desk Office for Internal Revenue Service; New Executive Office Building; Washington, D.C. 20503. The Internal Revenue Service requests persons submitting comments to OMB to also send copies of the comments to the Service.

LIST OF SUBJECTS IN 26 CFR Part 48

Agriculture, Arms and munitions, Coal, Excise taxes, Gasohol, Gasoline, Motor vehicles, Petroleum, Sporting goods, Tires.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on February 29, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 1, 1988, 53 F.R. 6524).

Notice of Proposed Rulemaking

Generation-Skipping Transfer Tax Regulations Under Chapter 13 of the Internal Revenue Code

LR-128-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: This document contains proposed generation-skipping transfer tax regulations. This action is necessary because of changes in the applicable tax law made by the Tax Reform Act of 1986. The Internal Revenue Service is issuing temporary regulations, in *** [T.D. 8187, page

332, this Bulletin], that provide rules relating to the generation-skipping transfer tax. The text of the temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: Written comments and requests for a public hearing must be delivered or mailed by May 16, 1988. The regulations are proposed to apply to any generation-skipping transfer after October 22, 1986.

ADDRESS: Send comments and request for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-128-86), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION

BACKGROUND

The temporary regulations in *** [T.D. 8187, page 332, this Bulletin], remove Parts 26 and 26a of Title 26 of the Code of Federal Regulations and replace them with a new Part 26. The regulations provide rules relating to Chapter 13 of the Internal Revenue Code of 1986, as added by section 1431 of the Tax Reform Act of 1986 (Pub. L. 99-51, 100 Stat. 2085). The regulations also provide rules relating to the effective date of this chapter, as added by section 1433 to the Tax Reform Act 1986 (Pub. L. 99-514, 100 Stat. 2085). This document proposes to adopt those temporary regulations as final regulations. Accordingly, the text of the temporary regulations serves as the comment document for this notice of proposed rulemaking. In addition, the preamble to the temporary regulations provides a discussion of the proposed and temporary rules.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required. Although this document is a notice of proposed rulemaking that solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that notice and public procedure requirements of 5 U.S.C. §553 do not apply. Accordingly these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

The collection of information requirements contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget (OMB) for review under section 3504(h) of the Paperwork Reduction Act. Comments on these requirements should be sent to the Office of Information and Regulatory Affairs of OMB, Attention: Desk Officer for Internal Revenue Service, New Executive Office Building, Washington, D.C. 20503. The Internal Revenue Service requests that persons submitting comments on these requirements to OMB also send copies of these comments to the Service.

LIST OF SUBJECTS IN 26 CFR 26

Estate taxes, Generation-skipping transfer.

LIST OF SUBJECTS IN 26 CFR 26a

Estate taxes, Generation-skipping transfer, Tax Reform Act of 1976.

LIST OF SUBJECTS IN 26 CFR 602

Reporting and recordkeeping requirements.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on March 14, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 15, 1988, 53 F.R. 8459)

Notice of Proposed Rulemaking Limitation on Deduction for Nonbusiness Interest: Personal Interest

LR-137-86

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: *** [page 80, this Bulletin], the Internal Revenue Service is issuing temporary amendments to the income tax regulations relating to the treatment of personal interest and the treatment and determination of qualified residence interest. Changes to the law were made by the Tax Reform Act of 1986. The text of those temporary regulations also serves as the comment document for this proposed rulemaking.

DATES: The regulations contained in this document are proposed to be effective for taxable years beginning after December 31, 1986. Written comments and requests for a public hearing must be delivered or mailed by February 22, 1988.

ADDRESS: Send comments and requests for public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-137-86), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary regulations (designated by a T following the section citation) in the Rules and Regulations *** [page 80, this Bulletin], amend Part 1 of Title 26 of the Code of Federal Regulations. These amendments reflect the provisions of section 163(h) of the Internal Revenue Code of 1986 as added by section 511(b) of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2246 [1986-3 C.B. (Vol. 1) 1, 163]. For the text of the temporary regulations, *** (T.D. 8168) *** [page 80, this Bulletin]. A general discussion of the temporary regulations is contained in the preamble to the regulations. The final regulations, which this document proposes to base on the temporary regulations, would amend Part 1 of Title

26 of the Code of Federal Regulations.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required. Although this document is a notice of proposed rulemaking that solicits public comments, the Internal Revenue Service has concluded that the proposed regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, a regulatory flexibility analysis is not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The collection of information requirements contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget (OMB) for review under section 3504(h) of the Paperwork Reduction Act. Comments on the requirements should be sent to the Office of Information and Regulatory Affairs of OMB, Attention: Desk Officer for Internal Revenue Service, New Executive Office Building, Washington, D.C. 20503. The Internal Revenue Service requests that persons submitting comments on these requirements to OMB also send copies of those comments to the Service.

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who submitted comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

* * * * *

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on December 21, 1987, and published in the issue of the Federal Register for December 22, 1987, 52 F.R. 48452)

Notice of Proposed Rulemaking

Requirement for Certain Partnerships and S Corporations to Separately State Meal, Travel, and Entertainment Expenses

LR-29-87

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: *** [T.D. 8182, page 258, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to the requirement for certain partnerships and S corporations to separately state certain meal, travel, and entertainment expenses. The text of the temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: Written comments and requests for a public hearing must be delivered or mailed by May 2, 1988. The regulations are proposed to be effective for taxable years beginning on or after January 1, 1987.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-29-87) Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION

BACKGROUND

The temporary regulations *** amend 26 CFR Part 1. For the text of the temporary regulations see *** [T.D. 8182, page 258, this Bulletin]. The preamble to the temporary regulations explains the addition to the regulations.

SPECIAL ANALYSES

Although this document is a notice of proposed rulemaking that solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6). The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis is therefore not required.

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request of any person who has submitted written comments. If a public hearing is held, notice of time and place will be published in the FEDERAL REGISTER.

LIST OF SUBJECTS IN 26 CFR 1.701-1—1.771-1

Income taxes, Partnerships.

LIST OF SUBJECTS IN 26 CFR 1.1361-0A—1.1388-1

Income taxes, Small business, Subchapter S corporation, Cooperatives.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on March 1, 1988, 8:45 a.m., and published in the issue of the Federal Register for March 2, 1988, 53 F.R. 6670).

Notice of Proposed Rulemaking

Electronic Filing of Notice of Federal Tax Lien

LR-39-87

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to a notice of Federal tax lien filed by the use of an electronic or magnetic medium. These regulations are proposed to clarify existing regulations under section 6323(f) of the Code.

DATES: Written comments and requests for a public hearing must be delivered or mailed by April 25, 1988.

The amendments to the regulations are proposed to be effective for a notice of Federal tax lien filed on or after February 23, 1988.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-39-87), Washington, D.C. 20224.

SUPPLEMENT INFORMATION:

BACKGROUND

These regulations propose to amend Part 301 of Title 26 of the Code of Federal Regulations to clarify that the term "Form 668" includes a notice of Federal tax lien filed by the use of an electronic or magnetic medium where the law of the state in which a notice of Federal tax lien is filed permits such method of filing.

IN GENERAL

Section 6321 of the Code imposes a lien in favor of the United States whenever a person liable for any tax neglects or refuses to pay the tax after demand. For such lien to be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor, a notice of the lien must be filed which meets the requirements of section 6323(f). Section 6323(f)(3) provides that the form and content of the notice referred to in section 6323(a) shall be prescribed by the Secretary, and that such notice is valid notwithstanding any other provision of law regarding the form or content of a notice of lien.

NOTICE OF LIEN MAY BE FILED BY THE USE OF AN ELECTRONIC OR MAGNETIC MEDIUM

Section 301.6323(f)-1(c) of the regulations provides that notice of a Federal tax lien "shall be filed on Form 668, 'Notice of Federal Tax Lien under Internal Revenue Law'." These proposed regulations clarify that the term "Form 668" includes both a Form 668 printed on paper and a Form 668 filed by the use of an electronic or magnetic medium if the law of the state in which the notice is filed permits a notice of Federal tax lien to be filed by the use of such medium. The use of a non-paper form will not affect the decision to place a notice of lien on file and will not significantly affect the timing of issuance of a notice of lien. Rather, the use of a non-paper form merely simplifies the manner of transmitting information to a state after a lien is determined to be valid and any remaining issues are resolved. Paper forms will continue to be used in states that do not permit electronic or magnetic filing.

The use of electronic or magnetic media to file a notice of tax lien will enable the Internal Revenue Service to better serve the public by (a) reducing the time it takes to notify the public that a lien exists; (b) reducing the amount of paperwork necessary to file a notice; and (c) in certain cases, eliminating or reducing the cost of filing a notice of lien, which cost is generally billed to the taxpayer involved.

REFILING A NOTICE OF LIEN

Section 6323(g) of the Code and §301.6323(g)-1 of the regulations, which govern the refiling of a notice of Federal tax lien, do not require a particular form to be used in refiling a notice of Federal tax lien. Therefore, an amendment to the regulations is not necessary to allow a notice of Federal tax lien to be refiled by the use of any electronic or magnetic medium permitted by the state in which the notice is refiled.

SPECIAL ANALYSES

Although this document is a notice of proposed rulemaking that solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6). The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required.

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

* * * * *

Proposed amendments to the regulations

The proposed amendments to 26 CFR Part 301 are as follows:

Paragraph 1. The authority for Part 301 is amended by adding the following citation:

Authority: 26 U.S.C. 7805*** Section 301.6323(f)-1(c) is also issued under 26 U.S.C. 6323(f)(3).

Par. 2. Section 301.6323(f)-1(c) is revised to read as follows:

(c) *Form*—(1) *In general.* The notice referred to in §301.6323(a)-1 shall be filed on Form 668, "Notice of Federal Tax Lien under Internal Revenue Laws". Such notice is valid notwithstanding any other provision of law regarding the form or content of a notice of lien. For example, omission from the notice of lien of a description of the property subject to the lien does not affect the validity thereof even though State law may require that the notice contain a description of the property subject to the lien.

(2) *Form 668 defined.* The term "Form 668" generally means a paper form. However, if a state in which a notice referred to in §301.6323(a)-1 is filed permits a notice of Federal tax lien to be filed by the use of an electronic or magnetic medium, the term "Form 668" includes a Form 668 filed by the use of any electronic or magnetic medium permitted by that state. A Form 668 must identify the taxpayer, the tax liability giving rise to the lien, and the date the assessment arose regardless of the method used to file the notice of Federal tax lien.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on February 22, 1988, 8:45 a.m., and published in the issue of the Federal Register for February 23, 1988, 53 F.R. 5279)

Notice of Proposed Rulemaking

Taxable Years of Certain Entities

LR-45-87

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: *** [page 146, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to taxable years of personal service corporations, partnerships and S corporations (and owners of those entities). Changes to the applicable law were made by the Tax Reform Act of 1986. The text of those temporary regulations also serves as the comment document for this proposed rulemaking.

DATES: Written comments and requests for a public hearing must be mailed or delivered by February 22, 1988. The amendments are proposed to be effective for taxable years beginning after December 31, 1986.

ADDRESS: Send comments and requests for public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-45-87) Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary regulations (designated by a "T" following the section citation) *** [page 146, this Bulletin], amend Part 1 of Title 26 of the Code of Federal Regulations. These amendments are proposed to conform the regulations to the requirements of section 806 of the Tax Reform Act of 1986 (Pub. L. 99-514), 100 Stat. 2362 [1986-3 C.B. (Vol. 1)1, 279]. For the text of the temporary regulations, see *** (T.D. 8167) *** [page 146, this Bulletin]. The preamble to the temporary regulations provides a discussion of the rules. The final regulations, which this document proposes to base on those temporary regulations, would amend Part 1 of Title 26 of the Code of Federal Regulations.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required. Although this document is a notice of proposed rulemaking that solicits public comments, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, a regulatory flexibility analysis is not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

* * * * *

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on December 18, 1987, 3:21 p.m., and published in the issue of the Federal Register for December 23, 1987, 52 F.R. 48546)

Notice of Proposed Rulemaking

Corporate Alternative Minimum Tax Book Income Adjustment of Foreign Corporations

LR-55-87

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: *** [T.D. 8197, page 18, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to the corporate alternative minimum tax adjustment for the book income of foreign corporations. The text of the temporary regulations also serves as the text for this Notice of Proposed Rulemaking.

DATES: Written comments and requests for a public hearing must be delivered or mailed by June 27, 1988.

ADDRESS: Send comments and request for a public hearing to Commissioner of Internal Revenue, Attention: CC:LR:T (LR-55-87), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary regulations in *** [T.D. 8197, page 18, this Bulletin] amend Part 1 of Title 26 of the Code of Federal Regulations. The temporary regulations are designated by a "T" following their section citation. The final regulations which are proposed to be based on the temporary regulations would amend Part 1 of Title 26 of the Code of Federal Regulations. The regulations provide rules relating to the book income adjustment to the corporate alternative minimum tax under section 56(c)(1) and 56(f) of the Internal Revenue Code of 1986 (Code) as added by section 701 of the Tax Reform Act of 1986 (Pub. L. 99-514; 100 Stat. 2320).

For the text of the temporary regulations see T.D. 8197 *** [page 18, this Bulletin]. The preamble to the temporary regulations provides a discussion of the rules.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. Although this document is a notice of proposed rulemaking that solicits public comment, the Internal Revenue Service has concluded that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

LIST OF SUBJECTS IN 26 CFR 1.01-1.58-8

Income taxes, Tax liability, Tax rates, Credits.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on April 27, 1988, 8:45 a.m., and published in the issue of the Federal Register for April 28, 1988, 53 F.R. 15234)

Notice of Proposed Rulemaking

Treatment of Salvage and Reinsurance under Section 832(b)

LR-65-87

AGENCY: Internal Revenue Service, Treasury

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: *** [t]he Internal Revenue Service is issuing temporary regulations relating to the treatment of salvage and reinsurance in determining the paid and unpaid losses of property and casualty insurance companies. The text of the temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: Written comments and requests for a public hearing must be delivered or mailed by March 7, 1988. The regulations are proposed to be effective as of January 1, 1988, and apply to taxable years beginning after December 31, 1987.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-65-87), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary regulations (designated by a "T" following the section citation) *** [page 266, this bulletin], amend Part 1 of Title 26 of the Code of Federal Regulations to provide rules relating to section 832(b)(5) of the Internal Revenue Code of 1986. This document proposes to adopt those temporary regulations as final regulations. Accordingly, the text of the temporary regulations serves as the comment document for this notice of proposed rulemaking. In addition, the preamble to the temporary regulations provides a discussion of the proposed and temporary rules.

For the text of the temporary regulations, see *** [page 266, this bulletin].

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291. Therefore, a regulatory impact analysis is not required. Although this document is a notice of proposed rulemaking that solicits comments, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations are not subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who submitted comments. If a public hearing is held, notice of the time and place will be published in the **FEDERAL REGISTER.**

* * * * *

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on December 30, 1987, 1:51 p.m., and published in the issue of the Federal Register for January 5, 1988, 53 F.R. 153)

Notice of Proposed Rulemaking

Deductions in Excess of $5,000 Claimed for Charitable Contributions of Certain Property

LR-83-87

AGENCY: Internal Revenue Service, Treasury

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed amendments to the income tax regulations relating to deductions in excess of $5,000 claimed for charitable contributions of certain property. The proposed regulations would provide substantiation rquirements with which all donors must comply with respect to charitable contributions of certain property if the amount claimed or reported as a deduction with respect to the contribution exceeds $5,000.

DATES:

PROPOSED EFFECTIVE DATES

The regulations are proposed to be effective for certain charitable contributions of property made after the date that is 30 days after a Treasury decision on this subject is published in the *Federal Register*.

DATES FOR COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Written comments and requests for a public hearing must be delivered or mailed by July 5, 1988.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-83-87), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On December 31, 1984, the *Federal Register* published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 170(a) and 6050L of the Internal Revenue

Code of 1954, as well as temporary regulations (T.D. 8003) [1985-1 C.B. 64] containing the same rules. The temporary regulations set forth substantiation requirements with which individuals, closely held corporations, personal service corporations, partnerships, and S corporations must comply with respect to charitable contributions of certain property made after December 31, 1984, if the amount claimed or reported as a deduction with respect to the contribution exceeds $5,000. Treasury decision 8199, *** [page 99, this Bulletin], finalizes the temporary and proposed regulations. The final regulations add the requirement that C corporations (as defined in section 1361(a)(2)) must comply with some of the substantiation requirements contained in the regulations with respect to contributions of certain property made after June 6, 1988.

This document contains proposed amendments to §1.170A-13 of the Income Tax Regulations (26 CFR Part 1), as amended by T.D. 8199.

EXPLANATION OF PROVISIONS

The proposed regulations would apply all the substantiation requirements contained in §1.170A-13(c) to all donors (including C corporations, trusts, estates, and pooled income funds) with respect to contributions of certain property made after the date that is 30 days after a Treasury decision on the subject of this notice of proposed rulemaking is published in the *Federal Register*.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. Although this document is a notice of proposed rulemaking that solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, the proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably seven copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the *Federal Register*. The collection of information requirements contained herein have been submitted to the Office of Management and Budget (OMB) for review under section 3504(h) of the Paperwork Reduction Act. Comments on the requirements should be sent to the Office of Information and Regulatory Affairs for OMB, Attention: Desk Officer for Internal Revenue Service, New Executive Office Building, Washington, D.C. 20503. The Internal Revenue Service requests persons submitting comments to OMB to also send copies of the comments to the Service.

* * * * *

Proposed amendments to the regulations.

The proposed amendments to 26 CFR Part 1 are as follows:

Paragraph 1. The authority for Part 1 continues to read in part:

Authority: 26 U.S.C. 7805. *** Section 1.170A-13 also issued under 26 U.S.C. 170 and section 155 of the Deficit Reduction Act of 1984 (98 Stat 691).

Par. 2. Paragraph (a)(1) of §1.642(C)-1 is amended by revising the first sentence to read as set forth below.

§1.642(c) 1 Unlimited deduction for amounts paid for charitable purpose.

(a) *In general.* (1) Any part of the gross income of an estate or trust which, pursuant to the terms of the governing instrument, is paid (or treated under paragraph (b) of this section as paid) during the taxable year for a purpose specified in section 170(c) shall be allowed as a deduction to such estate or trust in lieu of the limited charitable contributions deduction authorized by section 170(a) (provided that the recordkeeping and return requirements for charitable contribution deductions contained in §1.170A-13 are satisfied). ***

Par. 3. Section 1.642(c)-2 is amended by adding a new paragraph (e) immediately after paragraph (d) to read as set forth below.

§1.642(c)-2 Unlimited deduction for amounts permanently set aside for a charitable purpose.

* * * * *

(e) *Substantiation requirements.* No deduction shall be allowed under paragraphs (a), (b)(2), or (c) of this section unless the recordkeeping and return requirements for charitable contribution deductions contained in §1.170A-13 are satisfied.

Par. 4. Section 1.170A-13 is amended as follows:

1. The heading for paragraph (c) is revised to read as set forth below.

2. Paragraph (c)(1)(i) is revised to read as set forth below.

3. Paragraph (c)(1)(ii) is redesignated as paragraph (c)(1)(iii) and a new paragraph (c)(1)(ii) is inserted after paragraph (c)(1)(i) to read as set forth below.

4. Paragraph (c)(2)(ii)(B)(*3*) is revised to read as set forth below.

5. Paragraph (c)(4)(iv)(A) is revised to read as set forth below.

§1.170A-13 Recordkeeping and return requirements for deductions for charitable contributions.

* * * * *

(c) *Deductions in excess of $5,000 for charitable contributions of certain property*—(1) *General rule*—(i) *In general.* No deduction under section 170 shall be allowed with respect to a charitable contribution to which this paragraph (c) applies unless the substantiation requirements described in paragraph (c)(2) of this section are met. This paragraph (c) applies to any charitable contribution described in paragraph (c)(1)(ii) of this section made by any donor after [THE DATE THAT IS 30 DAYS AFTER A TREASURY DECISION ON THE SUBJECT OF THIS NOTICE OF PROPOSED RULEMAKING IS PUBLISHED IN THE FEDERAL REGISTER]. It also applies to any such contribution made before that date as follows:

(A) In the case of an individual, closely held corporation, personal service corporation, partnership, or S corporation if made after December 31, 1984, and

(B) In the case of a C corporation (as defined in section 1361(a)(2) of the Code) if made after June 6, 1988. (See paragraph (c)(2)(ii) of this section for special rules with respect to contributions made by C corporations on or before [THE DATE THAT IS 30 DAYS AFTER A TREASURY DECISION ON THE SUBJECT OF THIS NOTICE OF PROPOSED RULEMAKING IS PUBLISHED IN THE FEDERAL REGISTER].

(ii) *Charitable contribution.* Paragraph (c)(1)(i) of this section applies to a charitable contribution of an item of property (other than money and publicly traded securities to which paragraph (c)(7)(xi)(B) of this section does not apply) if the amount claimed or reported as a deduction under section 170 with respect to such item exceeds $5,000. For purposes of this paragraph (c), the amount claimed or reported as a deduction for an item of property is the aggregate amount claimed or reported as a deduction for a charitable contribution under section 170 for such item of property and all similar items of property (as defined in paragraph (c)(7)(iii) of this section) by the same donor for the same taxable year (whether or not donated to the same donee).

* * * * *

(2) *Substantiation requirements.* ***

(ii) *Special rules for certain nonpublicly traded stock, certain publicly traded securities, and contributions by certain C corporations.* ***

(b) ***

(*3*) The contribution by a C corporation (as defined in section 1361(a)(2)), other than a closely held corporation or a personal service corporation, of an item of property or of similar items of property described in paragraph (c)(1) of this section made after June 6, 1988, and on or before [THE DATE THAT IS 30 DAYS AFTER A TREASURY DECISION ON THE SUBJECT OF THIS NOTICE OF PROPOSED RULEMAKING IS PUBLISHED IN THE FEDERAL REGISTER].

* * * * *

(4) *Appraisal summary.* ***

(iv) *Special rules—(A) Content of appraisal summary required in certain cases.* With respect to contributions of nonpublicly traded stock described in paragraph (c)(2)(ii)(B)(*1*) of this section contributions of securities described in paragraph (c)(7)(xi)(B) of this section, and contributions described in paragraph (c)(2)(ii)(B)(*3*) of this section made after June 6, 1988, and on or before [THE DATE THAT IS 30 DAYS AFTER A TREASURY DECISION ON THE SUBJECT OF THIS NOTICE OF PROPOSED RULEMAKING IS PUBLISHED IN THE FEDERAL REGISTER] by a C corporation, the term "appraisal summary" means a document that—

(*1*) Complies with the requirements of paragraph (c)(4)(i)(A) and (B) of this section,

(*2*) Includes the information required by paragraph (c)(4)(ii)(A) through (H) of this section,

(*3*) Includes the amount claimed or reported as a charitable contribution deduction, and

(*4*) In the case of securities described in paragraph (c)(7)(xi)(B) of this section, also includes the pertinent average trading price (as described in paragraph (c)(7)(xi)(B)(*2*)(*iii*) of this section).

* * * * *

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on May 4, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 5, 1988, 53 F.R. 16156)

Notice of Proposed Rulemaking

Limitations on Passive Activity Losses and Credits

LR-14-88

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: [On page 191, this bulletin] the Internal Revenue Service is issuing temporary regulations relating to the limitations on passive activity losses and passive activity credits. Changes to the applicable tax law were made by the Tax Reform Act of 1986. The text of those temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATE: Except as otherwise provided in §1.469-11T, the amendments to the regulations are proposed to be effective for taxable years beginning after December 1986. Written comments and requests for a public hearing must be delivered or mailed by April 25, 1988.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-14-88), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary regulations (designated by a T following the section citations) *** [page 191, this Bulletin] amend the Income Tax Regulations (26 CFR Part 1) to provide rules relating to the limitations on passive activity losses and passive activity credits. The temporary regulations reflect the amendment of the Internal Revenue Code of 1986 by sections 501 and 502 of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2233 and 2241), which added section 469 (relating to the limitations on passive activity losses and passive ativity credits). This document proposes to adopt the temporary regulations as final regulations. Accordingly, the text of the temporary regulations serves as the comment document for this notice of proposed rulemaking. In addition, the preamble to the temporary regulations explains the proposed and temporary rules.

For the text of the temporary regulations, see FR Doc. (T.D. 8175) published *** [page 191, this Bulletin]

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis is not required. Although this document is a notice of proposed rulemaking that solicits public comment, the Internal Revenue Service has concluded that the proposed regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations are not subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferable eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who submitted comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

LIST OF SUBJECTS IN 26 CFR 1.441-1 - 1.483-2

Income taxes, Accounting, Deferred compensation plans.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on February 19, 1988, 4:19 p.m., and published in the issue of the Federal Register for February 25, 1988, 53 F.R. 5733)

Notice of Proposed Rulemaking

Nonaccrual-Experience Method of Accounting

LR-26-88

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In *** [T.D. 8194, page 186, this Bulletin], the Internal Revenue Service is issuing temporary amendments to the income tax regulations relating to the nonaccrual-experience method of accounting. The text of those temporary regulations also serves as the comment document for this proposed rulemaking.

DATES: Written comments and requests for a public hearing must be delivered or mailed by June 14, 1988.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-26-88), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION

BACKGROUND

The temporary regulations (designated by a "T" following the section citation) *** [T.D. 8194, page 186, this Bulletin] amend Part 1 of Title 26 of the Code of Federal Regulations. These amendments clarify the computation of the bad debt ratio for purposes of the nonaccrual-experience method under section 448(d)(5) of the Internal Revenue Code of 1986 as added by section 801 of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2085). For the text of the temporary regulations, see *** [T.D. 8194, page 186, this Bulletin]. A general discussion of the temporary regulations is contained in the preamble to the regulations. The final regulations, which this document proposes to base on the temporary regulations, would amend Part 1 of Title 26 of the Code of Federal Regulations.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required. Although this document is a notice of proposed rulemaking that solicits public comments, the Internal Revenue Service has concluded that the proposed regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, a regulatory flexibility analysis is not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who submitted comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

LIST OF SUBJECTS IN 26 CFR 1.441-1—1.483-2

Income taxes, Accounting, Deferred compensation plans.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on April 14, 1988, 8:45 a.m., and published in the issue of the Federal Register for April 15, 1988, 53 F.R. 12534)

Notice of Proposed Rulemaking

Section 1502—Consolidated Return Regulations

LR-28-88

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemkaing by cross-reference to temporary regulations.

SUMMARY: In *** [T.D. 8188, page 327, this Bulletin], the Internal Revenue Service is issuing temporary regulations that add new §1.1502-32T to the consolidated return regulations. Section 1.1502-32T supplements the adjustment under §1.1502-32(g) on the disposition by a member of stock of a subsidiary. The text of the new temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES:

PROPOSED EFFECTIVE DATES

The final regulations under section 1502 are proposed to be effective for stock of a subsidiary that ceases to be a member of an affiliated group filing a consolidated return during a taxable year of the group ending after November 30, 1987. A member may elect to apply the new rules to stock not otherwise covered by such rules if the stock is disposed of in a taxable year ending after November 30, 1987.

DATES FOR COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Written comments and requests for a public hearing must be delivered or mailed by May 16, 1988.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T [LR-28-88], Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

Temporary regulations published in *** [T.D. 8188, page 327, this Bulletin] add new temporary regulations §1.1502-32T to Part 1 of Title 26 of the Code of Federal Regulations ("CFR"). Final regulations are proposed to be based on the new temporary regulations. The final regulations generally would require a member of an affiliated group filing a consolidated return to reduce its basis in the stock of a disaffiliated subsidiary when the disaffiliated subsidiary distributes its earnings and profits. For the text of the new temporary regulations, see T.D. 8188 published in *** [page 327, this Bulletin]. The preamble to the temporary regulations explains the additions to the regulations.

EXECUTIVE ORDER 12291 AND REGULATORY FLEXIBILITY ACT

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. Furthermore, the Secretary of the Treasury has certified that this rule, if issued, will not a have a significant economic impact on a substantial number of small entities. The rule applies only to affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. It would not significantly alter the reporting or recordkeeping duties of small entities. A regulatory flexibility analysis is therefore not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUEST FOR A PUBLIC HEARING

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

The collection of information requirements contained herein have been submitted to the Office of Management and Budget (OMB) for review under section 3504(h) of the Paperwork Reduction Act. Comments on the requirements should be sent to the Office of Information and Regulatory Affairs of OMB, Attention: Desk Officer for Internal Revenue Service, New Executive Office Building, Washington, D.C. 20503. The Internal Revenue Service requests persons submitting comments to OMB to also send copies of the comments to the Service.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on March 14, 1988, 5:14 p.m., and published in the issue of the Federal Register for March 17, 1988, 53 F.R. 8773)

Notice of Proposed Rulemaking

Automatic Extension of Time to File Partnership Return of Income and Trust Income Tax Return

LR-29-88

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In *** [T.D. 8190, page 394, this Bulletin], the Internal Revenue Service is issuing temporary regulations relating to the automatic extension of time to file partnership returns of income and trust income tax returns. The text of those temporary regulations also serves as the comment document for this proposed rulemaking.

DATES: The regulations contained in this document are proposed to be effective for partnership and trust returns required to be filed for taxable years beginning after December 31, 1986. Written comments and requests for a public hearing must be delivered or mailed by June 6, 1988.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-29-88), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary regulations (designated by a "T" following the section citation) in the Rules and Regulations portion of this issue of the FEDERAL REGISTER amend Part 1 of Title 26 of the Code of Federal Regulations. These amendments reflect the provisions of section 6081(a) of the Internal Revenue Code of 1986. For the text of the temporary regulations, see *** [T.D. 8190, page 394, this Bulletin]. The preamble of the temporary regulations contains a discussion of the regulations. The final regulations, which this document proposes to base on the temporary regulations, would amend Part 1 of Title 26 of the Code of Federal Regulations.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required. Although this document is a notice of proposed rulemaking that solicits public comments, the Internal Revenue Service has concluded that the proposed regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, a regulatory flexibility analysis is not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The collection of information requirements contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget (OMB) for review under section 3504(h) of the Paperwork Reduction Act. Comments on the requirements should be sent to the Office of Information and Regulatory Affairs of OMB, Attention: Desk Officer for Internal Revenue Service, New Executive Office Building, Washington, D.C. 20503. The Internal Revenue Service requests that persons submitting comments on these requirements to OMB also send copies of those comments to the Service.

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferably eight copies) the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who submitted comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

LIST OF SUBJECTS IN 26 CFR §§1.6001-1—1.6109-2

Income taxes, Administration and procedure, Filing requirements.

26 CFR 602

Reporting and recordkeeping requirements.

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on March 31, 1988; 2:08 p.m., and published in the issue of the Federal Register for April 5, 1988, 53 F.R. 11103)

Notice of Proposed Rulemaking

Consolidated Return Regulations—Deferral of Gain or Loss

LR-47-88

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary and final regulations.

SUMMARY: In *** [T.D. 8196, page 325, this Bulletin], the Internal Revenue Service is issuing temporary and final regulations top rovide rules to taxpayers concerning the application of the consolidated return regulations to complete liquidations of subsidiary members of consolidated groups. The text of the temporary and final regulations also serves as the comment document for this notice of proposed rulemaking.

DATES:

PROPOSED EFFECTIVE DATE

The regulations are proposed to apply to taxable years for which the due date (without extensions) of the income tax return is after April 14, 1988.

DATE FOR COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Written comments and requests for a public hearing must be delivered or mailed by June 17, 1988.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T [LR-47-88], Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

Temporary regulations published in *** [T.D. 8196, page 325, this Bulletin], amend temporary regulation §1.1502-13T and add a new temporary regulation §1.1502-14T to Part 1 of Title 26 of the Code of Federal Regulations (CFR), and make conforming amendments to §§1.1502-13 and 1.1502-14. The final regulations that are proposed to be based on these temporary regulations would be added to Part 1 of Title 26 of the CFR. Those final regulations would provide rules on the treatment of gain or loss recognized on complete liquidations within a group of corporations that files consolidated returns. For the text of the new temporary regulations, see T.D. 8196, published in *** [page 325, this Bulletin]. The preamble to the temporary regulations explains the regulations.

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. Furthermore, the Secretary of the Treasury has certified that this rule, if issued, will not have a significant economic impact on a substantial number of small entities. The rule applies only to affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. It would not significantly alter the reporting or recordkeeping duties of small entities. A regulatory flexibility analysis is therefore not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER

Lawrence B. Gibbs,
Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on April 14, 1988, 8:45 a.m., and published in the issue of the Federal Register for April 18, 1988, 53 F.R. 12705)

Notice of Proposed Rulemaking

Election of Taxable Year Other Than Required Year by Partnerships, S Corporations and Personal Service Corporations

LR-53-88

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: In *** [T.D. 8205, page 156, this Bulletin] the Internal Revenue Service is issuing temporary regulations relating to the election of a taxable year other than the required year by a partnership, S corporation or personal service corporation. Changes to the applicable law were made by the Revenue Act of 1987. In addition, the regulations include conforming and clarifying rules regarding the determination of the taxable year of a partnership under section 706. The text of those temporary regulations also serves as the comment document for this notice of proposed rulemaking.

DATES: The amendments to the regulations are proposed to be effective generally for taxable years beginning after December 31, 1986. Written comments and requests for a public hearing must be delivered or mailed by July 26, 1988.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-53-88), Washington, D.C. 20224.

SUPPLEMENTARY INFORMATION:

BACKGROUND

The temporary regulations (designated by a "T" following the section citations) in *** [T.D. 8205, page 156, this Bulletin] amend the Income Tax Regulations (26 CFR Part 1) to provide temporary rules relating to the election by a partnership, S corporation, or personal service corporation to use a taxable year other than the year required (the "required year") under the applicable provision of the Internal Revenue Code of 1986 (the "Code"). The temporary regulations reflect the amendment of the Code by section 10206 of the Revenue Act of 1987 (Pub. L. 100-203, 101 Stat. 1330), which added sections 444, 7519 and 280H. Section 444 provides for the election (a "section 444 election") to use a taxable year other than the required year. A partnership or S corporation that makes or continues a section 444 election must make the payment required by section 7519. A personal service corporation that makes or continues a section 444 election is subject to the deduction limitations imposed by section 280H. This document proposes to adopt the temporary regulations as final regulations. Accordingly, the text of the temporary regulations serves as the comment document for this notice of proposed rulemaking. In addition, the preamble to the temporary regulations explains the proposed and temporary rules.

For the text of the temporary regulations, see FR Doc. (T.D. 8205) published in *** [page 156, this Bulletin].

SPECIAL ANALYSES

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required. Although this document is a notice of proposed rulemaking that solicits public comments, the Internal Revenue Service has concluded that the proposed regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations are not subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The reporting requirements contained in this notice of proposed rulemaking have been submitted in accordance with the requirements of the Paperwork Reduction Act of 1980 to the Office of Management and Budget (OMB) for review. OMB has approved these requirements (control number 1545-1036).

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before these proposed regulations are adopted, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who submitted written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

LIST OF SUBJECTS IN 26 CFR 1.441-1—1.483-2

Income taxes, Accounting, Deferred compensation plans.

26 CFR 1.7519-0T—1.7519-3T

Income taxes, Administrative and procedure, Miscellaneous, Required payments.

26 CFR 1.701-1—1.771-1

Income taxes, Partnerships.

26 CFR 1.61-1—1.281-4

Income taxes, Taxable income, Deductions, Exemptions

26 CFR 602

Reporting and recordkeeping requirements.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on May 24, 1988, 8:45 a.m., and published in the issue of the Federal Register for May 27, 1988, 53 F.R. 19715)

Announcement of the Disbarment, Suspension, or Consent to Voluntary Suspension of Attorneys, Certified Public Accountants, Enrolled Agents and Enrolled Actuaries from Practice Before the Internal Revenue Service

Under 31 Code of Federal Regulation, Part 10, an attorney, certified public accountant, enrolled agent or enrolled actuary, in order to avoid the institution or conclusion of a proceeding for his disbarment or suspension from practice before the Internal Revenue Service, may offer his consent to suspension from such practice. The Director of Practice, in his discretion, may suspend an attorney, certified public accountant, enrolled agent or enrolled actuary in accordance with the consent offered.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify practitioners under consent suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorneys, certified public accountant, enrolled agent or enrolled actuary and the date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletin for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended and will later be consolidated and published in the Cumulative Bulletin.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Term of Suspension
Samuel N. Cogan	Lawrenceville, NJ	Certified Public Accountant	Thirty Months from October 29, 1987
David M. Haught	Huntington, WV	Certified Public Accountant	Indefinite from November 18, 1987
Harry O. Fuller	Lockport, NY	Attorney	Indefinite from Oct. 23, 1987
Joseph Hazen	Armonk, NY	Certified Public Accountant	Indefinite from Dec. 8, 1987
Murray Hyman	Bayside, NY	Certified Public Accountant	Indefinite from Dec. 23, 1987
John F. Papsidero	N. Tonawanda, NY	Attorney	Indefinite from Dec. 21, 1987
Harvey Tanton	New York, NY	Certified Public Accountant	Indefinite from Dec. 8, 1987
Robert D. Bell	St. Louis, MO	Enrolled Agent	Eight Months from Jan. 1, 1988
Thomas R. Cantwell	Ft. Worth, TX	Certified Public Accountant	Indefinite from Jan. 13, 1988

Name	Address	Designation	Term of Suspension
Avery B. Klein	Cleveland, OH	Attorney	Indefinite from Jan. 6, 1988
Harry L. McCabe	Ft. Collins, CO	Attorney	Indefinite from Jan. 13, 1988
Richard A. Mueller, Jr.	Wauwatosa, WI	Enrolled Agent	Indefinite from Jan. 6, 1988
Jerome S. Cardin	Baltimore, MD	Attorney	Indefinite from Feb. 10, 1988
Herbert S. Ezrin	Potomac, MD	Attorney	Indefinite from Feb. 9, 1988
Berry L. Kessler	Columbus, OH	Enrolled Agent	Indefinite from Feb. 1, 1988
Yang I. Kim	Carlisle, MA	Certified Public Accountant	Indefinite from Jan. 28, 1988
David Monoker	Westover, MD	Attorney	Indefinite from Jan. 25, 1988
James W. Richards	Rush, NY	Attorney	Indefinite from Feb. 23, 1988
Kenneth A. Stoecklin	Crystal River, FL	Certified Public Accountant	Indefinite from Feb. 11, 1988
Alfred L. Brown	Indianapolis, IN	Attorney and Certified Public Accountant	Indefinite from Mar. 7, 1988
J. Gilbert Brown	Philadelphia, PA	Certified Public Accountant	Indefinite from Mar. 7, 1988
Claude T. Marshall	Boron, CA	Certified Public Accountant	Indefinite from Mar. 17, 1988
Albert H. Aston, Jr.	Kingston, PA	Attorney	Indefinite from March 25, 1988
John R. Graney	Le Roy, NY	Attorney	Indefinite from February 9, 1988

Name	Address	Designation	Term of Suspension
Peter A. Harris	**East Rochester, NY**	**Attorney**	**Indefinite from March 25, 1988**
Philip L. Herr	**San Diego, CA**	**Enrolled Agent**	**Indefinite from March 25, 1988**
Arnold I. Kramer	**Chicago, IL**	**Attorney**	**Three Years from March 29, 1988**

Under Section 330, Title 31 of the United States Code, the Secretary of the Treasury, after due notice and opportunity for hearing, is authorized to suspend or disbar from practice before the Internal Revenue Service any person who has violated the rules and regulations governing the recognition of attorneys, certified public accountants, enrolled agents or enrolled actuaries to practice before the Internal Revenue Service.

Attorneys, certified public accountants, enrolled agents and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by or sharing fees with, any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify such disbarred or suspended practitioners, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been disbarred or suspended from such practice, their designation as attorney, certified public accountant, enrolled agent or enrolled actuary, and the date of disbarment or period of suspension. This announcement will continue to appear in the weekly Bulletin for five successive weeks for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended or disbarred and will later be consolidated and published in the Cumulative Bulletin.

After due notice and opportunity for hearing, the following individuals have been disbarred from further practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Frank Calvo	Miami, FL	Certified Public Accountant	November 23, 1987
George R. Kucera	San Jose, CA	Attorney	March 11, 1988
Robert F. Ranson	San Diego, CA	Certified Public Accountant	March 4, 1988
Edward F. Berry	Haverton, PA	Enrolled Agent	April 11, 1988
John Sieczkowski	Middleton, MA	Certified Public Accountant	April 23, 1988
Murray R. Sweet	Overland Park, KS	Certified Public Accountant	April 23, 1988

After due notice and opportunity for hearing, the following individual has been suspended from further practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Cecil A. Hartman	Denver, CO	Attorney	One Year From October 2, 1987

Under 31 Code of Federal Regulations, Part 10, an enrolled agent, in order to avoid the institution of a proceeding for his disbarment or suspension from practice before the Internal Revenue Service, may offer his resignation. The Director of Practice, in his discretion, may accept the offered resignation of an enrolled agent.

To enable the public and other practitioners to identify such resigned enrolled agents, the Director of Practice will announce in the Internal Revenue Bulletin the name and address of each enrolled agent who has resigned and the effective date of resignation. This announcement will appear in the weekly Bulletin at the earliest practicable date after the action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each resigned enrolled agent, and will later be consolidated and published in the Cumulative Bulletin.

The following individual has entered a consent resignation from enrollment to practice before the Internal Revenue Service:

Name of Enrolled Agent	Address	Effective Date of Resignation
David C. Ballard	Windsor, NY	March 15, 1988

Index

The abbreviation and number in parentheses following the index entry refer to the specific item; numbers following the parentheses refer to the page number on which it appears.

Key to Abbreviations:

RR	Revenue Ruling
RP	Revenue Procedure
TD	Treasury Decision
CD	Court Decision
PL	Public Law
EO	Executive Order
DO	Delegation Order
TDO	Treasury Department Order
TC	Tax Convention
SPR	Statement of Procedural Rules
PTE	Prohibited Transaction Exemption

EMPLOYMENT TAX

- Administration:
  - User fees, requests for rulings, opinion letters and determination letters (RP 8) 628
- Forms:
  - Paper substitutes, Forms 1096, 1098, 1099 series, 5498 & W-2G (RP 28) 804
  - Substitute, computer-prepared and computer-generated (RP 7) 589
- Instrumentalities:
  - FICA, hospital insurance, state and political subdivision employees (RR 36) 343
- Liens:
  - Notice, electronic filing, Form 668 (TD 8174) 399
- Proposed regulations:
  - 26 CFR 1.6042-5, 1.6044-6, 31.3406(a)-3, added; 1.6041-1, 1.6041-3, 1.6041-4, 1.6041-7, 1.6042-2, 1.6042-3, 1.6042-4, 1.6043-2, 1.6044-2, 1.6044-3, 1.6044-5, 1.6045-1, 1.6049-4, 1.6049-5, 1.6049-6, 1.6050A-1, amended; information reporting, backup withholding, brokers, payees (INTL-52-86) 892
  - 26 CFR 301.6323(f)-1T, added; filing Form 668 (temporary) (LR-39-87) 927
- Railroad retirement:
  - Rate determination, quarterly 344
- Regulations:
  - 26 CFR 301.6323(f)-1T, added; filing Form 668 (temporary) (TD 8174) 399

EMPLOYMENT TAXES—Continued

- Returns:
  - Information, reproduction of Forms 1096, 1098, 1099 series, 5498 and W-2G (RP 28) 804
- Rulings:
  - Areas in which advance rulings will not be issued (RP 3) 579
  - Issuance procedures:
    - Background file documents (RP 11) 636
    - Determination letters, closing agreements (RP 1) 557
    - Mailing address (International) (RP 4) 586
  - Technical advice to District Directors and Chiefs, Appeals Offices, issuance procedures (RP 2) 571
  - User fees, requests for rulings, opinion letters and determination letters (RP 8) 628

ESTATE & GIFT TAXES ADMINISTRATIVE

- Administration:
  - User fees, requests for rulings, opinion letters and determination letters (RP 8) 628
- Liens:
  - Notice, electronic filing, Form 668 (TD 8174) 399
- Penalties:
  - Preparers, Form 1041, waiver (Notice 48) 531
- Proposed regulations:
  - 26 CFR 301.6323(f)-1T, added; filing Form 668 (temporary) (LR-39-87) 927
- Regulations:
  - 26 CFR 301.6323(f)-1T, added, filing Form 668 (Temporary) (TD 8174) 399
- Rulings:
  - Areas in which advance rulings will not be issued (RP 3) 579
  - Issuance procedures:
    - Background file documents (RP 11) 636
    - Determination letters, closing agreements (RP 1) 557
    - Mailing address (International) (RP 4) 586
  - Technical advice to District Directors and Chiefs, Appeals Offices, issuance procedures (RP 2) 571
  - User fees, requests for rulings, opinion letters and determination letters (RP 8) 628

ESTATE & GIFT TAXES ADMINISTRATIVE—Continued

- Trusts:
  - Income of beneficiaries attributable to a short taxable year (Notice 45) 529

ESTATE TAX

- Marital deduction, residuary bequest, valuation, estate expenses, South Carolina (RR 12) 330
- Proposed regulations:
  - 26 CFR Parts 26 & 26a, removed; Part 26 added; generation-skipping transfers (temporary) (LR-128-86) 925
- Regulations:
  - 26 CFR Parts 26 & 26a, removed; Part 26 added; generation-skipping transfers (temporary) (TD 8187) 332

GIFT TAX

- Charitable, etc., transfers:
  - "Lead" annuity interest, guaranteed prepayment (RR 27) 331

EXCISE TAXES

- Administration:
  - User fees, requests for rulings, opinion letters and determination letters (RP 8) 628
- Communications:
  - Local telephone service, leases, customer premises equipment (RR 5) 359
- Extension of time:
  - Gasoline, floor stocks (Notice 12) 481
- Liens:
  - Notice, electronic filing, Form 668 (TD 8174) 399
- Manufacturers:
  - Gasoline:
    - Exempt users, credit or refund (Notice 13) 481
    - Floor stocks, extension of time (Notice 12) 6, *11*
    - Floor stocks tax (Notice 44) 528
    - Gasohol, refund procedures (Notice 26) 495
    - Gasohol blenders, transitional procedures (Notice 34) 516
    - Registered gasohol blenders (Notice 2) 473
    - Removal or sale, refiner or importer or terminal operator (Notice 16) 482

EXCISE TAXES—Continued

- Manufacturers—Continued
  - Sporting goods:
    - Definitions, sport fishing equipment (RR 52) 356
- Pension plans:
  - Distributions, excess (TD 8165) 365
- Proposed regulations:
  - 26 CFR 1.163-5T(d)(7), added; sanctions on issuers of registration-required obligations (INTL-905-87) 922
  - 26 CFR 48.4041-21T, added; election, tax imposed on sale to retailers (temporary) (LR-114-86) 925
  - 26 CFR 54.4981A-1T, added; tax on excess distributions and excess accumulations (Temporary) (EE-162-86) 880
  - 26 CFR 145.4052-1, amended; retail tax, heavy trucks, trailers, semi-trailers, tractors (LR-17-86) 923
  - 26 CFR 301.6323(f)-1T, added; filing Form 668 (temporary) (LR-39-87) 927
- Refunds and credits:
  - Certain ultimate purchasers, "LUST" rate (Notice 46) 530
  - Gasoline, exempt users (Notice 13) 481
- Regulations:
  - 26 CFR 41.6001-3, 41.4483-7, added; 41.4481-1, 41.4481-3, 41.4482(c)-1, 41.4483-5, 41.6091-1, 602.101(c), amended; heavy vehicle use tax, foreign-based, reduction (TD 8177) 360
  - 26 CFR 48.4041-21T, added; election, tax imposed on sale to retailers (Temporary) (TD 8181) 344
  - 26 CFR 51.4996-1, amended; definition, newly discovered oil (TD 8185) 381
  - 26 CFR 54.4981A-1T, added; tax on excess distributions and excess accumulations (Temporary) (TD 8165) 365
  - 26 CFR 145.4052-1, amended; retail tax, heavy trucks, trailers, semi-trailers, tractors (TD 8200) 351
  - 26 CFR 301.6323(f)-1T, added; filing Form 668 (temporary) (TD 8174) 399
- Rulings:
  - Areas in which advance rulings will not be issued (RP 3) 579
  - Issuance procedures:
    - Background file documents (RP 11) 636

EXCISE TAXES—Continued

- Rulings—Continued
  - Issuance procedures—Continued
    - Determination letters, closing agreements (RP 1) 557
    - Mailing address (International) (RP 4) 586
  - Technical advice to District Directors and Chiefs, Appeals Offices, issuance procedures (RP 2) 571
  - User fees, requests for rulings, opinion letters and determination letters (RP 8) 628
- Special fuels:
  - Diesel, election, tax imposed on sale to retailer (TD 8181) 344
  - Diesel and aviation fuel, collection of tax by producer (Notice 30) 497; (Notice 55) 539
- Transportation:
  - Property:
    - Leaking Underground Storage Tank Trust Fund, liability for tax (Notice 21) 488
- Use tax:
  - Highway, foreign based (TD 8177) 360
- Windfall profit tax:
  - Definition, newly discovered oil (TD 8185) 381
  - Inflation adjustment factor (Notice 29) 497; (Notice 43) 528; (Notice 64) 552

INCOME TAX

- Accounting methods:
  - Inventories:
    - LIFO discontinuance (Notice 23) 490
  - Nonaccrual-experience method (Notice 51) 535
  - Qualified discount coupons, section 481 adjustment (RR 30) 187
- Accounting periods:
  - Adoption, partnership, S corporations, personal service corporations (TD 8205) 156
  - Partnerships and S corporations, taxable years of owners (TD 8167) 146
  - S and personal service corporations, elections (Notice 10) 478
  - Tiered structure, personal service corporations, partnerships and S corporations (Notice 36) 517
  - Trusts, short year, annualization (Notice 18) 486
- Administration:
  - Delegation of authority:
    - Authority with respect to church inquiries and examinations (DO 137 (Rev. 2)) 470

INCOME TAX—Continued

- Administration—Continued
  - Delegation of authority—Continued
    - Deputy Commissioners (DO 193 (Rev. 1)) 470
    - Partnership and S corporation matters (DO 209 (Rev. 3)) 471
    - Seizure and forfeiture of personal property (DO 157 (Rev. 5)) 470
    - Tax treaties, competent or taxation authority (DO 114 (Rev. 8)) 470
  - Form 5452, user fee eliminated (RR 27) 804
  - Merchant Marine, capital construction fund, interest rate (Notice 63) 551
  - User fees, requests for rulings, opinion letters and determination letters (RP 8) 628
- Automobiles:
  - Fringe benefits, cents-per-mile valuation rule (Notice 17) 486
- Bankruptcy and receiverships:
  - Federal Savings and Insurance Corporation, defaulted thrift institution placed into receivership (Notice 7) 476
- Banks:
  - Insolvent, collection of tax, deferral of collection (RR 18) 402
  - Ownership change, distressed financial institutions (Notice 57) 545
- Basis:
  - Property, jointly owned depreciable property, Michigan (RR 2) 405
- Bonds:
  - Mortgage revenue, state designation, area of chronic economic distress (RP 31) 832
  - Mortgage subsidy, state ceiling safe harbor limitations (RP 30) 831
  - Ruling requests, government obligations, nonissuing parties, outstanding obligations (RP 33) 835
  - Ruling requests under sections 103 & 7478 (RP 32) 833
  - State and local, section 149 (Notice 54) 539
  - States and subdivisions, information reporting, extension of time (RP 10) 635
- Business expenses:
  - Fines and penalties, assessed by EPA (RR 46) 76
- Capital expenditures:
  - Intangible drilling and development costs, exploratory holes (RR 10) 6, 5
  - Uniform capitalization rules, creative property, safe harbor (Notice 62) 548

- Charitable contributions:
  - Bargain sale, reduction, appreciated property (TD 8176) 94
  - Oil and gas lease overriding royalty or net profits interest (RR 37) 97
- Compensation paid:
  - Cafeteria plans, employer-provided dependent care assistance payments (Notice 3) 474
- Consolidated returns:
  - Adjustment, disposition of stock of subsidiary (TD 8188) 327
- Contracts:
  - Long-term, change to percentage of completion (Notice 66) 552
- Controlled corporations:
  - Allocation of income and deductions, controlling shareholder an employee (RR 38) 246
  - Stock distribution:
    - Active business requirement (RR 19) 114
    - Business purpose:
      - Fees and expenses (RR 33) 115
      - Hiring key employees (RR 34) 115
- Controlled foreign corporations:
  - Effectively connected income, factual determination (RR 3) 268
- Corporations:
  - Election, taxable year (Notice 40) 532
  - Reorganizations, substantially all (RR 48) 117
- Credits against tax:
  - Low-income housing, credit period, appropriate percentage (RR 6) 3
- Deductions:
  - General:
    - State and local and property taxes, Kansas City, Missouri School District (Notice 41) 526
- Deficiencies:
  - Interest rates, compounding (Notice 59) 546
  - Notice, rescission (RP 17) 692
- Depreciation:
  - MACRS, asset classes and recovery periods (RP 22) 785
- Dividends:
  - Received:
    - Consent dividends, qualifying corporations (TD 8166) 254
- Domestic international sales corporation (DISC):
  - Qualified export receipts (RR 11) 296
- Elections:
  - Fair market value, corporations, aggregation of dividends (RR 49) 297

- Elections—Continued
  - Section 754, partnership termination (RR 42) 265
- Employee plans:
  - Administrative:
    - Waivers, Omnibus Budget Reconciliation Act of 1987 (RP 20) 828
  - Contributions and benefits:
    - Attainment of age in determining benefits (Notice 25) 495
    - Section 457 application, eligible deferred compensation plans (Notice 68) 556
  - Distributions:
    - Excess deferrals, excess contributions, excess aggregate contributions (Notice 33) 513
    - Section 403(b) tax-sheltered arrangements (Notice 39) 525
  - Employee stock ownership plan:
    - Diversification requirements (Notice 56) 540
  - Funding:
    - Minimum funding, application for waivers (RP 5) 587
  - General:
    - Determination letters, qualified employee benefit plans (RP 9) 634
    - Limitations on alternative benefits, effective date, retroactive amendments (Notice 6) 476
    - Non-elective, deferred compensation, state and local governments and tax-exempt organizations (Notice 8) 477
    - Transfer of plan assets and liabilities (Notice 58) 546
  - Individual retirement arrangements:
    - Required distributions may be withdrawn, active participant even if the contribution is allocated in previous year (Notice 38) 524
  - Qualification:
    - Integration with social security, adoption date for plan amendments (Notice 9) 477
- Estates and trusts:
  - Estimated tax, underpayments (Notice 15) 482
  - Estimated tax of certain trusts, government depositaries (TD 8192) 397
- Estimated tax:
  - Estates and trusts, underpayments (Notice 15) 482
  - Government depositaries, certain trusts (TD 8192) 397

- Estimated tax—Continued
  - Penalties, farm waiver (Notice 28) 496
- Extension of time:
  - Persons outside the U.S. on April 15, 1988 (Notice 40) 526
- Farmers and farming:
  - Safe-harbor values, cattle produced (Notice 24) 491
- Foreign corporations:
  - Characteristics of partnership (RR 8) 403
  - Conversion to domestic corporation (RR 25) 116
  - Domestication, application of section 368(a)(1)(F) (Notice 50) 535
  - Elections:
    - Passive foreign investment companies, U.S. shareholders (TD 8178) 313
    - Treatment as domestic corporation, Netherlands Antilles (Notice 1) 471
  - Investment companies, definitional tests (Notice 22) 489
  - Passive foreign investment company, qualified electing fund (Notice 31) 511
  - Ships or aircraft, exemption, reciprocal exemption treaty article (Notice 5) 476
- Foreign insurance companies:
  - Estimated tax, effect of section 842 (Notice 52) 537
- Foreign tax credit:
  - Copy of paid receipt or return, requirement suspended (Notice 65) 552
  - International boycotts, countries requiring cooperation (Notice 14) 482; (Notice 61) 547
  - Panamanian income taxes (Notice 47) 530
- Forms:
  - 8271, tax shelter reporting requirements (Notice 32) 512
  - Paper substitutes, Forms 1096, 1098, 1099 series, 5498 & W-2G (RP 28) 804
  - Substitute, computer-prepared and computer-generated (RP 7) 589
- Franchises:
  - Amortization deductions, franchise transferred by a franchisee (RR 24) 306
- Fringe benefits:
  - Automobiles, cents-per-mile valuation rule (Notice 17) 486

Gain or loss:
  Recognition:
    Transferee corporation controlled by transferor (RR 32) 113
Government obligations:
  States and subdivisions
    Areas in which advance rulings will be issued (RP 26) 804
Gross income:
  Exclusions-inclusions:
    Fringe benefits, aircraft valuation formula (RR 40) 24
  When included:
    Cafeteria plans, dependent care assistance payments (Notice 3) 474
Husband and wife:
  Jointly owned property, Michigan (RR 2) 405
Industrial development bonds:
  Mass commuting vehicles (RR 51) 74
Insurance companies:
  Life:
    Reserves applicable interest rate (RR 16) 266
  Other than life or mutual:
    Losses incurred, salvage and reinsurance (TD 8171) 266
Interest:
  Investment:
    Federal rates, adjusted federal rates, adjusted federal long-term rate, and the long-term exempt rate (RR 1) 307; (RR 9) 307; (RR 15) 308; (RR 22) 309; (RR 28) 310; (RR 44) 312
  Paid:
    Partnerships and S corporations, allocation (Notice 20) 487
    Passthrough entities, reporting interest expense, debt-financed acquisitions and distributions (Notice 37) 522
  Received:
    Original issue discount, auction procedure (Notice 27) 496
Inventories:
  Change, automatic change to FIFO (RP 15) 683
  LIFO:
    Financial conformity requirement (RP 19) 695; (RR 21) 245
    Price indexes department stores, Nov. (RR 13) 241; Dec. (RR 20) 242; Jan. (RR 26) 242; Feb. (RR 35) 243; Mar. (RR 45) 244
  LIFO discontinuance, ordering rules (Notice 23) 490

Investment credit:
  Movie and television films (TD 8195) 17
  Qualified progress expenditures (TD 8183) 4
Involuntary conversions:
  Sale to effectuate policies of F.C.C., elections (RR 39) 299
Liens:
  Notice, electronic filing, Form 668 (TD 8174) 399
Losses:
  Passive activity, limitations (Notice 11) 481
Moving expenses:
  U.S. Government employee, transfers (RR 47) 111
Options:
  Contingent payment right (RR 31) 302
Overpayments:
  Adjusted interest rates (RR 17) 400; (RR 50) 401
  Interest rates, compounding (Notice 59) 546
Partnerships:
  Audits, tax matters partner (RP 16) 691
  Elections, taxable year (Notice 49) 532
  Interest paid, allocation (Notice 20) 487
  Limited:
    Tax classification (RR 43) 404
    Texas added, Uniform Limited Partnership Act (RR 23) 404
  Organization fee, treatment of the fee paid for tax opinion (RR 4) 264
  Organized under foreign law, lacks corporate characteristics (RR 8) 403
  Termination, section 754 election (RR 42) 265
  Withholding:
    Partnership distribution to foreign partners (RP 21) 777
Penalties:
  Preparers, Form 1041, waiver (Notice 48) 531
Personal expenses:
  2% floor, miscellaneous itemized deductions (TD 8189) 24
Personal holding company:
  Tax on retained income (RR 41) 253
Possessions of the United States:
  Puerto Rico, 1986 Tax Reform Act changes (Notice 35) 516

Proposed regulations:
  26 CFR 1.56-OT, 1.56-1T, amended; alternative minimum tax, foreign corporations (temporary) (LR-55-87) 929
  26 CFR 1.62-1T, 1.67-1T, 1.67-2T, added; 1.62-1, removed; 2% floor on miscellaneous itemized deductions (LR-97-86) 923
  26 CFR 1.163-5T, added; issuers of registration-required obligations, registration requirements (INTL-990-86) 916
  26 CFR 1.163-5T(d)(7), added; sanctions on issuers of registration-required obligations (INTL-905-87) 922
  26 CFR 1.163-9T, 1.163-10T, added; personal interest (Temporary) (LR-137-86) 926
  26 CFR 1.280H-0T, 1.280H-1T, 1.444-0T, 1.444-1T, 1.444-2T, 1.444-3T, 1.706-3T, 1.7519-0T, 1.7519-1T, 1.7519-2T, 1.7519-3T, added; 1.706-1T, revised; accounting period adoption, partnerships, S corporations, personal service corporations (temporary) (LR-53-88) 935
  26 CFR 1.410(a)-3T, 1.410(a)-8T, 1.410(a)-9T, 1.411(a)-3T, 1.411(a)-4T, 1.411(a)-8T, added; minimum vesting standards (Temporary) (EE-167-86) 88
  26 CFR 1.410(a)-4A, 1.411(b)-2, added; 1.411(a)-1, 1.411(a)-7, 1.411(c)-1, amended; employee benefit plan, accruals beyond normal retirement age (EE-184-86) 881
  26 CFR 1.414(q)-1T, 1.414(s)-1T, amended; definitions of "highly compensated" and "compensation" (EE-129-86) 880
  26 CFR 1.441-1, 1.441-2, redesignated as 1.441-1T & 1.441-2T & amended; 1.441-4T, 1.702-3T, 18.1366-5, added; 18.1366-1, 2, 3, and 4, added & reserved; taxable years of certain entities (Temporary) (LR-45-87) 929
  26 CFR 1.448-2T, amended; nonaccrual-experience method of accounting (LR-26-88) 933
  26 CFR 1.469-1T through 1.469-11T, added; passive activity losses and credits (LR-14-88) 932

Proposed regulations—Continued
  26 CFR 1.565-1, 1.565-2, 1.565-3, 1.565-5, 1.565-6, deleted; 1.565-1T, 1.565-2T, 1.565-3T, 1.565-5T, 1.565-6T, added; consent dividend provisions (Temporary) (INTL-313-87) 920
  26 CFR 1.642(c)-1, 1.642(c)-2, 1.170A-13, amended; charitable contributions, excess of $5000, estates and trusts (LR-83-87) 930
  26 CFR 1.702-1T, 1.1366-1T, added; partners and shareholders, separately state meal, travel, and entertainment expenses (temporary) (LR-29-87) 927
  26 CFR 1.706-1T, added; taxable years of certain partnerships (Temporary) (LR-101-86) 924
  26 CFR 1.832-4 redesignated as 1.832-4T and amended; treatment of salvage and reinsurance under section 832(b) (Temporary) (LR-65-87) 930
  26 CFR 1.861-8, revised; DISC and FSC, determination of income (INTL-128-87) 917
  26 CFR 1.897-1, 1.1445-2, 1.1445-5, amended; 1.897-4AT, 1.897-5T, 1.897-6T, 1.897-7T, 1.897-8T, 1.897-9T, 1.1445-9T, 1.1445-10T, added; certain dispositions, U.S. real property interests (INTL-491-87) 921
  26 CFR 1.904(f)-13T, added; foreign tax credit, limitations, transition rules (temporary) (INTL-932-86) 915
  26 CFR 1.1291-0T, 1.1291-10T, 1.1294-1T, 1.1295-1T, 1.1297-3T, added; elections, passive foreign investment companies, foreign corporations, U.S. shareholders (INTL-941-86) 916
  26 CFR 1.1502-13, 1.1502-14, 1.1502-13T, amended; 1.1502-14T, added; consolidated returns, deferral of gain or loss (LR-47-88) 935
  26 CFR 1.1502-32, amended; 1.1502-32T, added; consolidated returns, adjustment, disposition of stock of subsidiary (temporary) (LR-28-88) 933

Proposed regulations—Continued
  26 CFR 1.6042-5, 1.6044-6, 31.3406(a)-3, added; 1.6041-1, 1.6041-3, 1.6041-4, 1.6041-7, 1.6042-2, 1.6042-3, 1.6042-4, 1.6043-2, 1.6044-2, 1.6044-3, 1.6044-5, 1.6045-1, 1.6049-4, 1.6049-5, 1.6049-6, 1.6050A-1, amended; information reporting, backup withholding, brokers, payees (INTL-52-86) 892
  26 CFR 1.6081-2T, 1.6081-3T, added; time to file, automatic extension, partnership and trust returns (LR-29-88) 934
  26 CFR 301.6323(f)-1T, added; filing Form 668 (temporary) (LR-39-87) 927
Public utilities:
  Depreciation, average rate assumption method (RP 12) 637
Real estate investment trust:
  Built-in gain of C corporation assets (Notice 19) 486
Refunds and credits:
  Refund offset program, magnetic tape filing (RP 14) 639
Regulated investment companies:
  Built-in gain of C corporation assets (Notice 19) 695
  Inter-fund transactions, series investment companies (RR 14) 405
  Tax on retained income (RR 41) 253
Regulations:
  26 CFR 1.46-1, 1.46-3, 1.47-1, 1.47-3, amended; 1.46-5, added; investment credit, qualified progress expenditures (TD 8183) 4
  26 CFR 1.48-8, amended; investment credit, movie and television films (TD 8195) 17
  26 CFR 1.56-0T, 1.56-1T, amended; alternative minimum tax, foreign corporations (temporary) (TD 8197) 18
  26 CFR 1.62-1T, 1.67-1T, 1.67-2T, added; 1.62-1, removed; 2% floor on miscellaneous itemized deductions (TD 8189) 24
  26 CFR 1.67-3T, 1.860D-1T, 1.860F-4T, 1.6049-7T, added; REMIC, status election, return filing procedures (TD 8186) 37

Regulations—Continued
  26 CFR 1.88-1, 1.468A-1 through 1.468A-8, added; 1.88-1T, 1.468A-1T through 1.468A-8T, removed; nuclear decommissioning costs, ratemaking (TD 8184) 49
  26 CFR 1.163-5(c)(2)(i), 1.163-5(e)(2)(i)(B)(4), 1.163-5(c)(3), amended; issuers of registration-required obligations, registration requirements (TD 8203) 77
  26 CFR 1.163-5T, added; issuers of registration-required obligations, registration requirements (TD 8202) 78
  26 CFR 1.163-9T, 1.163-10T, added; personal interest (Temporary) (TD 8168) 80
  26 CFR 1.170A-4, 1.1011-2, amended; charitable contributions, bargain sale (TD 8176) 94
  26 CFR 1.170A-13T, 1.6050L-1T, removed; 1.170A-13, revised; 1.170A-14, amended; 1.6050L-1, added; charitable contributions, filing, dispositions of donated property (TD 8199) 99
  26 CFR 1.280H-0T, 1.280H-1T, 1.444-0T, 1.444-1T, 1.444-2T, 1.444-3T, 1.706-3T, 1.7519-0T, 1.7519-1T, 1.7519-2T, 1.7519-3T, added; 1.706-1T, revised; accounting period adoption, partnerships, S corporations, personal service corporations (Temporary) (TD 8205) 156
  26 CFR 1.410(a)-3T, 1.410(a)-8T, 1.410(a)-9T, 1.411(a)-3T, 1.411(a)-4T, 1.411(a)-8T, added; minimum vesting standards (Temporary) (TD 8170) 118
  26 CFR 1.414(b)-1, 1.414(c)-1, 1.414(c)-2, 1.414(c)-3, 1.414(c)-4, 1.414(c)-5, added; 1.52-1, 1.1563-1, 1.1583-3, 1.7476-1, 602.101(c), amended; 11.414(c)-1 through 11.414(c)-5, 13.16, 13.16-1, removed; common control, pension, profit-sharing, stock bonus plans, brother-sister group corporations (TD 8179) 122
  26 CFR 1.414(q)-1T, 1.414(s)-1T, amended; definitions of "highly compensated" and "compensation" (TD 8173) 134

Regulations—Continued
- 26 CFR 1.441-1, 1.441-2, redesignated as 1.441-1T, & 1.441-2T & amended; 1.441-4T, 1.702-3T, 18.1366-5, added; 18.1366-1, 2, 3, and 4, added & reserved; taxable years of certain entities (Temporary) (TD 8167) 146
- 26 CFR 1.448-2T, amended; nonaccrual-experience method of accounting (TD 8194) 186
- 26 CFR 1.469-1T through 1.469-11T, added; passive activity losses and credits (TD 8175) 191
- 26 CFR 1.482-2, 1.7872-5T, revised; safe-haven interest rates, rental charges for commonly controlled taxpayers (TD 8204) 246
- 26 CFR 1.565-1, 1.565-2, 1.565-3, 1.565-5, 1.565-6, deleted; 1.565-1T, 1.565-2T, 1.565-3T, 1.565-5T, 1.565-6T, added; consent dividend provisions (Temporary) (TD 8166) 254
- 26 CFR 1.702-1T, 1.1366-1T, added; partners and shareholders, separately state meal, travel, and entertainment expenses (temporary) (TD 8182) 258
- 26 CFR 1.706-1T, added; taxable years of certain partnerships (Temporary) (TD 8169) 259
- 26 CFR 1.832-4 redesignated as 1.832-4T and amended; treatment of salvage and reinsurance under section 832(b) (Temporary) (TD 8171) 266
- 26 CFR 1.897-1, 1.1445-2, 1.1445-5, amended; 1.897-4AT, 1.897-5T, 1.897-6T, 1.897-7T, 1.897-8T, 1.897-9T, 1.1445-9T, 1.1445-10T, added; certain dispositions, U.S. real property interests (TD 8198) 270
- 26 CFR 1.904(f)-13T, added; foreign tax credit, limitations, transition rules (temporary) (TD 8201) 291
- 26 CFR 1.1291-0T, 1.1291-10T, 1.1294-1T, 1.1295-1T, 1.1297-3T, added; elections, passive foreign investment companies, foreign corporations, U.S. shareholders (TD 8178) 313
- 26 CFR 1.1502-13, 1.1502-14, 1.1502-13T, amended; 1.1502-14T, added; consolidated returns, deferral of gain or loss (TD 8196) 325

Regulations—Continued
- 26 CFR 1.1502-32, amended; 1.1502-32T, added; consolidated returns, adjustment, disposition of stock of subsidiary (temporary) (TD 8188) 327
- 26 CFR 1.6041-3, revised; exemption, information returns, certain non-profit organizations (TD 8193) 385
- 26 CFR 1.6050H-0 through 1.6050H-2, added; 1.6050H-1T, 602.101(c), amended; mortgage interest reporting, received in a trade or business from individuals (TD 8191) 387
- 26 CFR 1.6081-2T, 1.6081-3T, added; time to file, automatic extension, partnership and trust returns (TD 8190) 394
- 26 CFR 1.6302-2, added; government depositaries, estimated tax of certain trusts (TD 8192) 397
- 26 CFR 55.4981-1, 55.6011-1, 55.6061-1, 55.6071-1, revised; 55.6091-1, amended; 55.4981-2. 55.6151-1, added; real estate investment companies and regulated investment companies under the TRA of 1986 (TD 8180) 363
- 26 CFR 301.6036-1, amended; notice required of qualification of trustee or like fiduciary in bankruptcy (TD 8172) 383
- 26 CFR 301.6323(f)-1T, added; filing Form 668 (temporary) (TD 8174) 399

Residence:
- Rent-controlled apartment, gain, relinquished rights (RR 29) 75

Returns:
- Electronic filing, individual (RP 20) 696
- Extension of time, persons outside the U.S. on April 15, 1988 (Notice 40) 526
- Information:
  - Exemption, certain non-profit organizations (TD 8193) 385
  - Magnetic media reporting, Forms 1098, 1099, 5498 & W-2G (RP 36) 838
  - Reporting requirements, rental assistance payments (RR 53) 384
  - Reproduction of Forms 1096, 1098, 1099 series, 5498 & W-2G (RP 28) 804

Rulings:
- Areas in which advance rulings will be issued:
  - Corporate recapitalizations (RP 25) 803

Rulings—Continued
- Areas in which advance rulings will be issued—Continued
  - 80-percent distributee status (RP 34) 837
  - Safe harbor leases (RP 35) 837
  - State and local bonds (RP 26) 804
- Areas in which advance rulings will not be issued (RP 3) 579
- Determination letters, qualified employee benefit plans (RP 9) 634
- Employee plans, minimum funding standard, application for waivers (RP 5) 587
- Issuance prior to adoption of regulations (RP 18) 694
- Issuance procedures:
  - Background file documents (RP 11) 636
  - Determination letters, closing agreements (RP 1) 557
  - Mailing address (International) RP 4) 586
  - Public utilities, normalization requirements (RP 6) 589
  - Requests, government obligations, nonissuing parties, outstanding obligations (RP 33) 835
  - Requests under sections 103 & 7478 (RP 32) 833
  - Technical advice to District Directors and Chiefs, Appeals Offices, issuance procedures (RP 2) 571
- User fees:
  - Requests for rulings, opinion letters and determination letters (RP 8) 628
  - Small business corporations (RP 13) 639

Small business corporations:
- Election, taxable year (Notice 49) 532
- Interest paid, allocation (Notice 20) 487
- S and personal service corporations, accounting periods, elections (Notice 10) 478

States and subdivisions:
- Bonds, information reporting, extension of time (RP 10) 635

Stock:
- Convertible, determination of ownership (Notice 67) 555

Tax Conventions:
- American Samoa, exchange of information (TC) 408
- China, Peoples Republic of (TC) 414
- Netherlands Antilles, extension of deadline set in Notice 88-1 (Notice 53) 538

☆U.S. G.P.O. 1989-242-490:60056